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ALEXANDER L. STEVAS,
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No.

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1980

HOME MUTUAL INSURANCE COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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March 20, 1981

QUESTIONS PRESENTED

1. Whether the exclusionary "tax benefit rule" may be invoked, in the context of Section 832(b) of the Internal Revenue Code, to exclude certain items from a taxpayer's taxable income.

2. Whether the Respondent's construction and application of Section 832(b) of the Internal Revenue Code under the circumstances of the present case constitutes a violation of the constitutional limitations on the taxing power of the Congress, by imposing a tax on that which is not "income" within the meaning of the 16th Amendment.

PARTIES

All of the parties to this proceeding are listed in the caption of the case as set forth on the cover of this Petition. The only parent, subsidiary, or affiliate of the Petitioner is a subsidiary known as Homeco Life Insurance Co., Inc., 93.2% of whose outstanding stock is owned by Petitioner.

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OPINIONS BELOW

The opinions of the Court of Appeals herein are not yet reported officially. They are reported unofficially at 80-1 U.S.T.C. para. 9392, 45 A.F.T.R. 2d 80-1608 (original opinion) and 81-1 U.S.T.C. para. 9127, 47 A.F.T.R. 2d 81-503 (opinion on rehearing, en banc), and are printed in Appendix A hereto, *infra,* pages A-1, *et. seq.* The opinion of the United States Tax Court herein is reported at 70 T.C. 944 (1978), and is printed in Appendix B hereto, pages A-39, *et seq.*

JURISDICTION

The judgement of the Court of Appeals herein was originally entered on April 29, 1980. A copy of such judgment is set forth in Appendix C hereto, *infra,* at page A-61. By order dated July 22, 1980, this judgment was vacated and a rehearing, en banc, was granted with respect to the issues here presented. This order is reproduced in Appendix C hereto, at page A-62. The final judgment of the Court of Appeals, on rehearing, was entered on December 23, 1980. Such judgment is reproduced in Appendix C, *infra,* at page A-63. Jurisdiction of this Court to review such judgment is invoked under 28 U.S.C. Section 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

United States Constitution:

> *Article I, Section 2, Clause 3:* "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers ... ."
>
> *Article I, Section 9, Clause 4:* No Capitation, or other direct, Tax shall be laid, unless in proportion to the Census or Enumeration herein before directed to be taken."
>
> *Amendment Sixteen:* The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Internal Revenue Code of 1954 (26 U.S.C.):

> Section 111
> Section 821
> Section 823
> Section 832

The foregoing Internal Revenue Code provisions are lengthy, and the pertinent portions of their texts are set out in full in Appendix D hereto, *infra*, page A-65, *et seq.*

STATEMENT OF THE CASE

Petitioner is a mutual casualty insurance company, with its principal offices located in Appleton, Wisconsin. As a mutual insurance company, Petitioner is subject to the federal income tax under Chapter 1,

Subchapter L, Parts II and III of the Internal Revenue Code, Sections 821 through 832.[1] The present case involves the construction and application of certain provisions of Section 832 of the Code, in the context of what are known as an insurance company's "unpaid losses."

Briefly stated, the controversy arises from a change, enacted in 1962, in the method of computing the taxable income of mutual casualty insurance companies, such as Petitioner. With this change, such companies first became taxable on their "underwriting income" beginning with the year 1963. As a result of the application of a prescribed statutory formula for computing such underwriting income, however, a company whose "unpaid losses" as of December 31, 1962 later are proven to have been overestimated or "overaccrued" is required, at least by the literal terms of the pertinent statutory provisions, to increase its post-1962 taxable income by the amount of this overestimate, as it is later recovered. This is true regardless of the fact that the company enjoys no economic gain from its recovery of this overaccrual, and the fact that the overaccrual did not give rise to any corresponding reduction in its taxable income in any preceding year. It is Petitioner's position that under such circumstances the applicable statutory provisions should be construed, in light of other provisions of the Code as well as established non-statutory doctrines of income taxation, to exclude such recoveries of overaccrued unpaid losses from post-1962 taxable income, and that any application of the statute which fails to do so is violative of the constitutional limitations on the taxing power of Congress.

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[1] I.R.C. §821-32. All reference in the text to the "Code", the "Internal Revenue Code," or to Section numbers refer, unless otherwise stated, to the Internal Revenue Code of 1954, as amended.

For years prior to 1963, the federal income tax was not imposed on the underwriting income of mutual casualty insurance companies. Rather, the tax was imposed on the basis of such companies' gross premiums and/or investment income.[2] With the enactment of the Revenue Act of 1962[3] however, such taxpayers became subject to a federal income tax based on both their investment income and their "statutory underwriting income."[4] The present controversy involves certain elements of the computation of a mutual casualty insurance company's "statutory underwriting income" which, together with its "taxable investment income," forms the basis for its "mutual insurance company taxable income" upon which the income tax is imposed.[5]

"Statutory underwriting income" is to be determined, with certain modifications and adjustments not here pertinent, under the provisions of Sections 831 and 832, which govern the taxation of nonmutual casualty insurance companies. Sections 831 and 832 had been included in the Internal Revenue Code for some time prior to the 1962 Act; thus Congress merely adopted the preexisting statutory formula and applied it to mutual insurance companies.

Under Section 832 "statutory underwriting income" consists, essentially, of "premiums earned" during the year, less expenses and "losses incurred." The computation of this "losses incurred" deduction is the basis of the present controversy.

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[2] *See,* Int. Rev. Code of 1954, ch. 736 §§ 821, 822, 68A Stat. 260 (amended 1962).

[3] Pub. L. No. 87-834, 76 Stat. 960 (Effective with respect to taxable years beginning after December 31, 1962).

[4] I.R.C. §§ 821-26, *as amended by* Revenue Act of 1962, Pub. L. No. 87-834, § 8(a), (b), (c), 76 Stat. 960, 989-93 (Effective with respect to taxable years beginning after December 31, 1962).

[5] I.R.C. § 821(a), (b).

Under the formula prescribed by Section 832(b)(5) for the computation of "losses incurred,"[6] the taxpayer's "losses incurred" deduction for any particular taxable year consists of all losses actually paid during the year plus any increase (or minus any decrease) during the year in its accrued unpaid losses. "Unpaid losses" as of the end of a year consists, for these purposes, of the taxpayer's estimate of the amount which it will be required to pay on account of losses which have occurred prior to the end of the year. Thus, when the company receives notice of a claim having been made against one of its policies, it establishes an accrued liability on its books, and recognizes an expense, chargeable against current income, for the amount estimated to be necessary to discharge the claim. When each such claim, for which an unpaid loss accrual had been established, is ultimately paid, the accrued liability is removed from the company's books, to reflect the fact that it has been discharged. However, if the amount ultimately paid to settle a particular claim is less than the estimated liability therefor previously accrued in the unpaid losses

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[6] I.R.C. § 832(b)(5) provides, in pertinent part, as follows:

> "(5) LOSSES INCURRED. The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:
>
> (A) To losses paid during the taxable year ...
>
> (B) ... add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year."

The portion of the statute omitted in the above quotation concerns the adjustment which is prescribed for so-called "salvage and reinsurance recoverable," not directly at issue herein.

account (i.e., the unpaid loss was "overaccrued"), the excess amount of the accrual is proven to have been unnecessary, and accordingly is restored to the company's earned surplus.[7]

On its face, therefore, this formula for computing statutory underwriting income, as prescribed by Section 832, requires these recoveries of overaccrued unpaid losses to be included in, and increase the taxpayer's income for the years in which the losses are paid.[8] Thus, to the extent that unpaid losses are overstated as of the end of any taxable year, the taxpayer's losses incurred deduction for subsequent years will be understated, and its taxable income for such subsequent years will be correspondingly increased. Under ordinary circumstances, however, any such overstatement of unpaid losses as of the end of a taxable year will result in an understatement of taxable income for that year (by virtue of the fact that the balance in the unpaid loss account at the *end* of a year is *added* to the losses paid in computing the losses incurred deduction for that year), and hence the only effect of such an overstatement of unpaid losses will be to *shift* taxable income from one year to the next. However, in the case of mutual casualty insurance companies, an overaccrual of unpaid losses

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[7] In financial accounting terms, the entries made to record the unpaid loss accrual and the subsequent payment of the claim are as follows: When notice of a claim is received, an entry is made charging "losses incurred" (an expense account) and crediting "unpaid losses" (a liability account). When the claim is paid, a credit entry is made to "cash" (reflecting the cash outlay) and a charge is made to "unpaid losses" (eliminating the liability from the books). If the amount paid is less then the accrued unpaid loss, the difference is credited to earned surplus.

[8] This is due to the fact that, under the prescribed formula, the entire "unpaid losses" balance at the beginning of a year is subtracted from losses paid during the year, while only the amount actually paid in settlement of those unpaid losses is taken into account in determining "losses paid". *See,* I.R.C. § 832(b)(5).

at December 31, 1962 has no such effect, because mutual casualty insurance companies were not subject to the income tax on their underwriting income for years prior to 1963. In such a case, therefore, the effect of an overaccrual of unpaid losses at December 31, 1962 is to increase a taxpayer's taxable income for 1963 and later years *without* any corresponding decrease in *taxable* income for pre-1963 periods.

As of December 31, 1962, the total of Petitioner's unpaid losses, as accrued on its books, was $2,729,-746.00. During the years 1963 through 1975, Petitioner ultimately paid and disposed of all of the claims which comprised this December 31, 1962 balance, for a total net amount of $2,327,431.41.[9] Thus, Petitioner ultimately recovered and restored to its earned surplus a total of $402,314.59 of the losses which it had incurred and accrued prior to December 31, 1962. Under the literal terms of Section 832(b) of the Code, Petitioner was required to include this recovery in its post-1962 taxable income.

It is Petitioner's position herein that its recoveries of these overaccrued unpaid losses from pre-1963 years should not be included in its post-1962 taxable income, since the overaccrual of its December 31, 1962 balance produced no correlative reduction in Petitioner's taxable income for any prior period. Petitioner thus invokes the so-called "tax benefit rule,"[10] a well-established judicial doctrine of income taxation, now partially codified in Section 111 of the Code.[11]

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[9] This figure represents the total amount actually paid by Petitioner in full settlement of all of the claims comprising its unpaid losses balance as of December 31, 1962. The figure is stated net of salvage and subrogation recoveries received which were attributable to such claims.

[10] *See, Reasons for Granting Writ,* Section I.A. *infra.*

In its decision (Appendix B, page A-39, et seq.), the Tax Court found in favor of the Petitioner with respect to the unpaid losses issue. Accordingly, it found it unnecssary to reach the alternative salvage and subrogation issue.[12] On appeal to the Seventh Circuit,[13] the Court of Appeals reversed the Tax Court with respect to the unpaid losses issue and remanded the case to the Tax Court for a determination of the salvage and subrogation issue. Three members of the Seventh Circuit dissented from this opinion, holding that if applied in the manner proposed by Respondent, so as to tax pre-1962 unpaid loss recoveries, the statute in question would be unconstitutional. Before this Court, Petitioner seeks a reversal of the Court of Appeals' decision with respect to the unpaid losses issue. If the Court of Appeals is reversed with respect to this issue, no remand to the Tax Court will be necessary.

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[11] The deficiency in income taxes for the years at issue which was asserted by Respondent (and which therefore conferred Tax Court jurisdiction) (*See,* I.R.C. §§ 6213(a), 7442) did not involve the "unpaid losses" issue. Rather, it was based on Respondent's inclusion in Petitioner's post-1962 taxable income of certain cash recoveries of "salvage and subrogation" relating to pre-1963 losses paid. The Respondent's Regulations purport to require such recoveries to be taken into account as a reduction of "losses paid" in the year of recovery (and to therefore increase taxable income), regardless of whether or not the earlier payment of the loss to which they relate conferred any "tax benefit" on the taxpayer in the year of payment. *See Continental Insurance Co. v. U.S.,* 474 F.2d 661, 665 (Ct. Cl. 1973); Treas. Reg. §1.832-1(c), §1.832-4(c) (final sentences.) Petitioner had excluded such recoveries from its taxable income, in its returns as originally filed, on the ground that such recoveries related to earlier losses the payment of which resulted in no reduction in Petitioner's taxable income, due to the fact that when such losses were paid, prior to 1963, Petitioner was not taxed on its underwriting income. Thus Petitioner relied on the same "tax benefit rule" doctrine which it invokes in support of its position regarding the unpaid losses issue.

(footnote continued on following page)

REASONS FOR GRANTING THE WRIT

I. The Issue Presented By The Decision Of The Court Of Appeals Is Of Continuing Significance In The Administration And Interpretation Of The Income Tax Law.

A. The doctrine with which the case is concerned, the "tax benefit rule," is a well-established doctrine of income tax jurisprudence, applicable in a wide array of contexts throughout the tax laws.

As described in the Statement of the Case, *supra*, when an insurance company, such as Petitioner,

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Respondent's statutory notice of deficiency, asserting the additional tax due on account of the salvage and subrogation issue, was issued on April 14, 1975. On or about July 11, 1975, Petitioner filed its timely Petition to the United States Tax Court. Before the Tax Court, Petitioner not only contested Respondent's inclusion of these salvage and subrogation recoveries in taxable income, but also maintained, as its principal argument, that it should be entitled to a refund of taxes paid for the periods in issue on the ground that its overaccrued unpaid losses as of December 31, 1962 should be excluded from post-1962 taxable income. Because the amount by which the unpaid losses were overaccrued ($402,314.59) is computed *net* of any salvage and subrogation recoveries relating to such claims, the salvage and subrogation issue is raised only as an alternative position and need not be addressed if a finding is made in Petitioner's favor on the unpaid losses issue. Because of this fact, neither Court below addressed the salvage and subrogation issue on the merits, and it is not before this Court on the merits.

[12] *See* note 11, *supra*.

[13] Jurisdiction of the Court of Appeals to review decisions of the Tax Court is conferred by I.R.C. §7482.

settles a claim against its policies for an amount less than the amount which had been accrued therefor as an "unpaid loss," the company in effect "recovers" (and restores to its earned surplus) an amount which had previously been charged against its earnings as an expense or loss. By the operation of Section 832 of the Code, at least as literally worded, such "recoveries" are included in and serve to increase the company's taxable income for the year in which the claims are settled, even though the recoveries relate to losses incurred in years prior to 1963 when the occurrence of the losses did not reduce the taxable income of the company. In asserting that such recoveries of pre-1962 unpaid losses should not be includible in its post-1962 taxable income, Petitioner relies upon a well-established doctrine of income taxation known as the "tax benefit rule."

The "tax benefit rule" is a doctrine which evolved to prevent the imposition of the income tax upon amounts received by a taxpayer which do not represent any real economic gain to him. Now *partially* codified in Section 111 of the Code, the rule stands for the proposition that a taxpayer is not required to recognize as taxable income mere recoveries of a prior year's costs, expenses, losses or accruals *unless* the prior year's cost, expense, loss or accrual resulted in some "tax benefit" to the taxpayer. *Dobson v. Commissioner,* 320 U.S. 489 (1943). See, generally, 1 Mertens, *The Law of Federal Income Taxation,* § 7.34 (Rev. ed. 1974). A brief review of the history of this rule, its theoretical underpinnings, and its judicial application, will demonstrate its broad applicability in various contexts throughout the income tax law.

Prior to 1942 the tax benefit rule existed only in judicial decisions. In that year a portion of the rule was codified in Section 22(b)(12) of the Internal

Revenue Code of 1939.[14] Since then, the United States Supreme Court has led the way in a series of judicial decisions firmly establishing that the tax benefit rule is far broader in its application than the limited codification of Section 22(b)(12) (now Section 111).

Even though prior judicial decisions had established a far broader rule, Section 22(b)(12) of the 1939 Code, as adopted in 1942, and its supporting regulations,[15] referred only to the recovery of bad debts, taxes, and "delinquency amounts." This Court, however, basing its decision on pre-statutory judicial precedents, quickly established that the coverage of the tax benefit rule went far beyond these three items. In the landmark case of *Dobson v. Commissioner,* 320 U.S. 489 (1943), the Court excluded from taxable income amounts received by the taxpayer as a recovery of losses previously sustained on a sale of securities. Under the facts of *Dobson,* the taxpayer had sold certain securities, at a loss, in prior years. The facts of the case established that, even if these losses had not been sustained, the taxpayer's tax returns for the years in which the sales occurred would still have shown net losses, and therefore he had obtained no "tax benefit" from the losses when incurred. The taxpayer therefore contended that his later recovery of a portion of these losses was in the nature of a return of capital, representing no economic gain overall, and that since he had received no tax benefit from the loss deductions previously claimed this later recovery should not be included in income when received. In holding the recovery not includable in income this Court emphasized that the significant factor in determining includibility is whether the taxpayer received either an economic gain or a tax benefit from the "transaction"

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[14] Revenue Act of 1942, ch. 619, § 116, 56 Stat. 798 (Effective for taxable years beginning after December 31, 1938).

[15] Treas. Reg. 118, § 39.22(b)(12)-1 (1939 Code).

as a whole. In so holding, this Court made it clear that the tax benefit rule was to be given broad application and was not to be limited to those items specified in the statute, viewing the three items specifically mentioned in Section 22(b)(12) merely as examples of areas in which the tax benefit rule should apply, rather than as a definitive list. The Court rejected the Commissioner's contention that such recoveries are taxable income in the absence of a specific statutory exemption.

Numerous decisions subsequent to *Dobson* have followed this Court's directive in that case by expanding the coverage of the tax benefit rule to include various items not specified in Section 111. *See, e.g., California & Hawaiian Sugar Refin. Corp. v. U.S.*, 311 F.2d 235 (Ct. Cl. 1962) (recovery of previously-paid taxes); *American Financial Corp. v. Commissioner*, 72 T.C. 506 (1979) (mutual insurance company's recovery of salvage and subrogation); *Home Savings & Loan Co. v. Commissioner*, 39 T.C. 368 (1962), *acq.* 1963-2 C.B. 4, 1965-2 C.B. 5 (recovery of previously paid taxes); *Birmingham Terminal Co. v. Commissioner*, 17 T.C. 1011 (1951), *acq.* 1952-1 C.B. 1 (recovery of prior operating losses, even though receipts denominated "rent"); *M & E Corp. v. Commissioner*, 7 T.C. 1276 (1946), *acq.* 1947-1 C.B. 3 (recovery of prior accrued reserves for losses on mortgage loans); *Dallas Title & Guaranty Co. v. Commissioner*, 40 B.T.A. 1022 (1939), *rev'd on other grounds*, 119 F.2d 211 (8th Cir. 1941) (recovery of overaccrued estimated losses on title insurance policies). *See also*, Rev. Rul. 58-126, 1958-1 C.B. 13 (transfer to earned surplus of overestimated reserves for losses); Treas. Reg. § 1.111-1(a).

As the litany of cases discussed above makes clear, the courts, as well as the Internal Revenue Service itself, have expanded the scope and coverage of the tax benefit rule as a judicial doctrine of income taxation

that has far-reaching application in many factual contexts. Indeed, the rule is capable of being invoked, as these decisions make clear, in any context wherein the Code otherwise purports to tax a receipt which consists of only a recovery of a prior loss, expense, or accrual, rather than an item of "income" or gain in the economic sense. In light of the broad scope of the doctrine, any decision, such as that of the Seventh Circuit herein, which would affect a significant modification of that doctrine is deserving of review by this Court.

B. The decision of the Court of Appeals constitutes a significant, and conceptually unsound, departure from previously well-established "tax benefit rule" doctrine.

As discussed above, the tax benefit rule requires for its application that the taxpayer demonstrate the existence of two elements: first, the taxpayer's "recovery" of a prior loss, expense, or accrual which, absent the application of the rule, would result in an increase in its taxable income for the year of the recovery; second, the absence of gain or income in the economic sense from the transaction as a whole and the absence of a prior "tax benefit" from the earlier loss, expense or accrual.

In its opinions herein, the Court of Appeals clearly recognized that both of these elements were present in the instant case. *See,* Court of Appeals decision, slip. op. at 16-18, reproduced at Appendix A hereto, *infra,* at A-18-19.[16] However, after recognizing that these two

[16] Indeed, there can be no serious dispute that both the "recovery" element and "tax benefit" element of the rule are satisfied here. As recognized by the Court of Appeals, the mere fact that the

(Footnote continued on following page)

historic elements of the rule had been satisified by Petitioner, the Court of Appeals announced a third element of the tax benefit rule which, Petitioner submits, was heretofore unheard of in the jurisprudence of income tax law.[17] This new third element, as described by the Court below, would limit the application of the so-called "exclusionary" tax benefit rule to cases where the item in question is sought to be taxed solely and exclusively by virtue of the so-called "inclusionary" tax benefit rule, and preclude the application of the "exclusionary" rule where the item in question is assertedly taxable by virtue of the literal language of some particular provision of the Code.[18]

In referring to the "exclusionary" and "inclusionary" tax benefit rules, the Court below recognizes that there exist two separate but related

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"recovery" is in the form of bookkeeping entries rather than an acutal cash disbursement and receipt does not preclude the rule's application. *See,* Court of Appeals decision, slip op. at 17 (reproduced in Appendix A, at A-19), and cases there cited. And, as the Court of Appeals also recognized, the fact that the Petitioner was exempt from tax on its underwriting income when the unpaid losses were accrued is sufficient to establish the lack of a prior "tax benefit." *See,* Court of Appeals decision, slip op. at 17-18 (Appendix A, at A-19), and cases there cited. All reference herein to the Court of Appeals decision is to the original decision, dated April 29, 1980, unless otherwise indicated.

[17] *See,* Court of Appeals decision, slip op. at 18-21 (Appendix A, at A-20-22).

[18] Somewhat paradoxically, the Court of Appeals announced this as its holding in spite of its statement, earlier in its opinion, that the tax benefit rule "remains substantially extra-statutory in nature and affects a taxpayer's taxable income beyond the literal meaning of the Code itself. Thus it is not sufficient to rebut the invocation of the tax benefit rule to argue that the statute makes no provision for its use here ..." Court of Appeals decision, slip op. at 14 (Appendix A, at A-16). This statement would appear directly contradictory to the Court's later holding.

rules, both of which are commonly referred to as the "tax benefit rule." Under the exclusionary rule (invoked by Petitioner herein), a recovery of a prior loss, expense, or accrual is to be excluded from income in the year of the recovery where the prior expense or accrual produced no "tax benefit" in any earlier year. Under the inclusionary rule, a recovery of such a prior loss, expense, or accrual, even though not otherwise regarded as taxable income, is to be included in income where the taxpayer received a prior tax benefit from the earlier loss or expense which, as its subsequent recovery demonstrates, was unwarranted.[19] These two rules are, of course, closely related in that they both stem from the same theoretical and conceptual underpinnings, that is, that a mere recovery of a prior loss or expense is *not* an event which produces "income" or gain in the economic sense, and accordingly the only justification for including the recovery in income is the underlying premise that a prior tax benefit was received from the taxpayer's deduction of the earlier loss or expense.[20] Thus the inclusionary rule simply requires a taxpayer to relinquish its prior undeserved tax benefit by including its subsequent recovery in income. But when the underlying premise (the existence of a prior tax benefit) is shown to be false, the exclusionary rule requires the recovery to be excluded from income, for in the absence of a prior tax benefit no logical or conceptual grounds exist for taxing the recovery as "income."

In relegating the exclusionary tax benefit rule to the role of a limitation on the inclusionary tax benefit

[19] *See*, Bittker and Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. Rev., 265, 269 (1978).

[20] *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom. Union Trust Co. of Indianapolis v. Commissioner*, 111 F.2d 60 (7th Cir. 1940), *cert. denied* 311 U.S. 658 (1940); *Barnett v. Commissioner*, 39 B.T.A. 864, 867-68 (1939); Bittker and Kanner, *supra*, note 19, at 269, 271, 274.

rule, rather than an independent doctrine capable of application in a far broader range of circumstances, the Court of Appeals breaks new ground in the development of this doctrine of income tax law. Such a limitation has never been suggested by any prior decision of any court throughout the long history and development of the tax benefit rule. In announcing this new limitation, the Court of Appeals cites no supporting authority, stating only that "In the cases we have examined" the exclusionary aspect of the tax benefit rule has become relevant "only after the Commissioner has employed the inclusionary aspect of the rule ..."[21] citing *Home Savings & Loan Co. v. Commissioner,* 39 T.C. 368 (1962), as being "in accord with this analysis." In fact, *Home Savings* does not support the new rule laid down by the Court of Appeals; the decision therein merely recognizes that in *that case* the source of the Commissioner's authority to include the recoveries in income was the inclusionary tax benefit rule.

In fact, the exclusionary tax benefit rule *has* (contrary to the Court of Appeals' conclusion) been applied in several instances notwithstanding the fact that the items in question were assertedly includable in income under specific Code provisions rather than under the inclusionary tax benefit rule. *See, American Financial Corp. v. Commissioner,* 72 T.C. 506 (1979) (salvage and subrogation recoveries under Section 832(b)(5)); *Brimingham Terminal Co. v. Commissioner,* 17 T.C. 1011 (1951) ("rent"); Rev. Rul. 58-546, 1958-2 C.B. 143 and Rev. Rul. 67-200, 1967-1 C.B. 15 ("forgiveness of indebtedness" income ordinarily taxable under § 61(a)(12)). Just as importantly, of course, the Court of Appeals' holding totally ignores Section 111 of the Code, the statutory exclusionary tax

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[21] *See,* Court of Appeals decision, slip. op. at 18-19 (Appendix A, at A-20).

benefit rule, which is not, by its terms, limited in its application to cases wherein the Commissioner relies exclusively on the inclusionary rule.

In light of the fact that prior judicial precedents do not support a limitation on the exclusionary tax benefit rule such as that promulgated by the Court of Appeals herein, but rather reject such a limitation, and especially in view of the significance of the tax benefit rule as a doctrine of income tax law, as evidenced by the wide range of contexts in which it applies, it is important that this Court review the decison and holding of the Court of Appeals and evaluate the merits of the change which it would affect in this doctrine of income tax law.

II. The Decision Of The Court Of Appeals Is In Conflict With This Court's Decision In *Dobson v. Commissioner,* 320 U.S. 489 (1943).

In *Dobson*[22] this Court held that the income tax laws do not compel a finding of *taxable income* in a receipt arising out of a transaction from which the taxpayer in fact derived no economic gain, where the transaction produced no prior tax benefit. Although this Court in *Dobson* declined to label its holding a "rule of tax benefits,"[23] the *Dobson* decision has long been viewed as a recognition by this Court of the conceptual underpinnings of the tax-benefit rule.[24] Thus the significance of *Dobson* lies in its recognition of the fundamental principal that the income tax laws

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[22] *Dobson v. Commissioner,* 320 U.S. 489 (1943).

[23] 320 U.S. at 506.

[24] *See, Home Savings and Loan Co.,* 39 T.C. 368, 369-70 (1962); 1 Mertens, *The Law of Federal Income Taxation,* § 7.34 (Rev. 1974).

must be interpreted and applied to tax only that which is "income" in the economic sense, and its recognition of the fact that a taxpayer's recovery of a prior loss or expense does not constitute such income and accordingly should not be taxed in the absence of some prior tax benefit.

When the principals of the exclusionary tax benefit rule are thus considered, it becomes apparent that the limitation imposed by the Court of Appeals' decision in the present case contradicts those principles. By refusing to permit the application of the exclusionary rule where specific provisions of the Code purportedly require inclusion in income of the recoveries in question,[25] the Court of Appeals sanctions the taxation as "income," of that which is in fact not income. This is blatantly contrary to the principles established in *Dobson*. The question of whether *Dobson's* principles should be so limited should be decided only by this Court, and accordingly a writ of certiorari should issue to review the decision of the Court of Appeals in this respect.

III. The Decision Of The Court Of Appeals Is In Conflict With The Decisions Of Other Circuit Courts And The Court Of Claims Regarding The Scope Of The Tax Benefit Rule.

As discussed above, the decision of the Court of Appeals herein would preclude the application of the exclusionary tax benefit rule in any circumstances wherein the Commissioner can point to a specific provision of the Code which purports to require

[25] Compare the general "omnibus" inclusionary provision of the Code, Section 61, which provides, in pertinent part, "gross income means all income, from whatever source derived ...," I.R.C. § 61.

inclusion in income of the item in question. Petitioner submits that such a limitation, if upheld, would be directly contrary to the principles established by many recent decisions of several other Circuit and other courts involving the application of the *inclusionary* tax benefit rule to include a particular "recovery" in taxable income even in the face of express Code provisions excluding the item in question from taxable income.[26] These cases very clearly hold that the inclusionary tax benefit rule can "override" specific, express language of the Code which, by its terms, accords nonrecognition treatment to the item in question. Given the fact that both the inclusionary and exclusionary rules rest upon the same theory and concepts, it is a contradiction to hold that the *exclusionary* rule can *not* override express statutory language in an appropriate case while the inclusionary rule can. This is especially true when one considers the fact that the exclusionary rule has been given express recognition by Congress in Section 111 of the Code, whereas the inclusionary rule is entirely non-statutory.[27] It would be manifestly irrational for the

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[26] *See, e.g., Tennessee Carolina Transportation, Inc. v. Commissioner,* 582 F.2d 378 (6th Cir. 1978) (§ 336); *Connery v. U.s.,* 460 F.2d 1130 (3d Cir. 1972) (§ 337); *Spitalny v. U.S.,* 430 F.2d 195 (9th Cir. 1979) (§ 337); *Commissioner v. Anders,* 414 F.2d 1283 (10th Cir. 1969) (§ 337); *Mager v. U.S.,* 449 F.Supp. 37 (M.D. Pa. 1980) (§ 1033); *S.E. Evans v. U.S.,* 317 F.Supp. 423 (W.D. Ark. 1970) (§ 337); *Anders v. U.S.,* 462 F.2d 1147 (Ct. Cl. 1972) (§ 337); *Munter's Estate,* 63 T.C. 663 (1975) (§ 337); *McCamant,* 32 T.C. 824 (1959) (predecessor to § 101(a)). Cf, *South Lake Farms, Inc. v. Commissioner,* 324 F.2d 837 (9th Cir. 1963) (tax benefit rules does not override § 336). *See also,* O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders,* 27 Tax L. Rev. 216, 222-26, 233-36.

[27] Indeed, Section 111 is just as much a part of the Internal Revenue Code, and therefore just as applicable to the Petitioner's circumstances, as is Section 832(b). The Court of Appeals, however, refused to recognize this fact, despite Petitioner's urging.

decision of the Court of Appeals herein to exist side by side with these conflicting decisions of other courts. More importantly, it would be manifestly unjust to permit the law to exist in a status which permits the Commissioner of Internal Revenue to prevail on this issue when he invokes the inclusionary rule, yet refuses to permit taxpayers to prevail on what is in essence the same issue when they invoke the exclusionary rule. Therefore, it is submitted that it is appropriate for this Court to resolve this conflict by reviewing the decision of the Court of Appeals herein.

IV. The Statute In Question As Interpreted And Applied By The Court Of Appeals Violates Constitutional Limitations On Congress' Taxing Powers.

This Court very clearly established the principle that the taxing power of Congress under the 16th Amendment[28] is limited to the taxation of that which constitutes "income" in the economic sense.[29] In *Eisner,* this Court held that the Revenue Act of 1916, in purporting to tax "stock dividends" paid by a corporation to its shareholders, exceeded Congress' taxing power, for Congress could not invoke the 16th Amendment as a source of authority to tax, putatively as "income," that which is in fact not income to the taxpayer. Of course, as this Court recognized even in the course of its *Eisner* decision, it is well established that the 16th Amendment in and of itself does not *limit* Congress' taxing authority. Rather, it actually

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[28] The Sixteenth Amendment provides, "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

[29] *Eisner v. Macomber,* 252 U.S. 189 (1919).

expands that authority by creating an exception, for "income" taxes, to the general requirement that no "direct" tax may be imposed unless it is apportioned among the several states according to population.[30] Thus the 16th Amendment's effect is to sanction a non-apportioned "income" tax regardless of whether it may be determined to be a "direct" or an "indirect" tax.[31] Before any tax levied by Congress can be found to exceed Congress' constitutional taxing power, then, the tax in question must be found (1) to be a "direct" rather that an "indirect" tax, *and* (2) not to tax "income" in the economic sense.[32]

Approaching these two requirements in inverse order, it is plain that the statute in question, as applied by the Respondent to Petitioner's recoveries of overaccrued unpaid losses, does not tax "income" in the economic sense. Plainly the transaction whereby an insurance company incurs a loss, accrues it as an "unpaid loss" liability on its books, and later pays it,

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[30] U.S. Const. Art. I, § 2, cl. 3 and § 9, cl. 4. The only express constitutional limitation on Congress' power to impose an "indirect" tax is contained in Art. I, § 8, cl. 1, which requires that "... all Duties, Imports and Excises shall be uniform throughout the United States".

[31] In its opinion on rehearing below, the majority of the Seventh Circuit expressed its opinion that the 16th Amendment has been effectively rendered superfluous by this Court's decision in *New York ex. rel. Cohn v. Graves*, 300 U.S. 308 (1937), which, according to the Seventh Circuit majority, overruled this Court's earlier holding, in *Pollock v. Farmer's Loan and Trust Co.*, 157 U.S. 429 (initial decision), 158 U.S. 601 (on rehearing) (1895), that an income tax constituted a "direct" tax. In fact, however, the *Graves* decision has no such effect, as is apparent from a reading of it, for the Court in *Graves* expressly distinguished that case from *Pollock* and pointed out that its opinion should not be read to contradict *Pollock*. 300 U.S. at 315. In any event, however, the question of whether or not an "income" tax is a "direct" tax is at most tangentially relevant to the present case for, as will be demonstrated, the statute in question, as applied, does not tax "income."

does not give rise to any economic gain or benefit to the company. The company realizes no "income" from the transaction. Rather its income, if any, is generated through its receipt of premiums from its policyholders, and the process of incurring and paying claims against its policies only *reduces* its net underwriting income. Thus when an insurance company, such as Petitioner, finds that it has estimated and accrued its unpaid losses at too high a figure, and that the payments which it will ultimately be required to make will be lesser in amount than originally anticipated, its "recovery" of the resulting "overaccrual" of its unpaid losses is hardly "income" in the economic sense. It is nothing more than a reduction in amount of the losses which it had earlier expected to be required to pay. The transaction is fundamentally no different than that in *Dobson,*[33] where the taxpayer recovered a portion of his loss on a sale of securities, resulting in a lesser loss than originally anticipated. Just as this Court recognized that such an event did not generate "income" in *Dobson,* so it does not generate "income" here. Indeed, the dissenting judges of the Seventh Circuit herein clearly recognized this fact.[34]

Having established that the statute as applied in the circumstances of the instant case would tax that which is not "income," it remains to be determined whether or not it constitutes a "direct" tax so as to require apportionment.[35]

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[32] *See, Simmons v. U.S.,* 308 F.2d 160 (4th Cir. 1962).

[33] 320 U.S. 489 (1943).

[34] *See,* Court of Appeals decision on rehearing, slip op. at 5-7 (Fairchild, Pell and Bauer, dissenting) (Appendix A, at A-35-37).

[35] It is obvious upon a review of the statute itself that the tax in question is not in fact apportioned among the States according to population (nor does it purport to be).

This Court has on only a few occasions considered the question of what is and is not a "direct" tax within the meaning of the Constitution.[36] Although the decided cases do not establish readily discernible guidelines applicable to every case, they do focus on a distinction between a tax on the receipt, transmittal, or use of property and a tax on the taxpayer's mere ownership of that property, the former generally regarded as "indirect," and the latter generally classified as "direct."[37]

Although none of the decided cases relating to this issue has involved a tax on a "recovery" such as is present in the instant case,[38] the general principles which those cases establish nonetheless imply that a tax on such a recovery is not properly classifiable as an "indirect" tax, and hence is subject to the apportionment requirement. As stated above, those types of taxes which have been classified as "indirect" are

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[36] *Scholey v. Rew*, 90 U.S. (23 Wall.) 331 (1875); *Pollock v. Farmer's Loan and Trust Co.*, 157 U.S. 429 (initial decision), 158 U.S. 601 (on rehearing) (1895); *Knowlton v. Moore*, 178 U.S. 41 (1900); *Bromley v. McCaughn*, 280 U.S. 124 (1929); *Fernandez v. Wiener*, 326 U.S. 340 (1945).

[37] *Scholey v. Rew*, 90 U.S. (23 Wall.) 331 (inheritance tax held "indirect"); *Pollock v. Farmer's Loan and Trust Co.*, 157 U.S. 429 (initial decision), 158 U.S. 601 (on rehearing) (1895) (income tax held "direct"); *Knowlton v. Moore*, 178 U.S. 41 (1900) (inheritance tax held "indirect"); *Bromley v. McCaughn*, 280 U.S. 124 (1929) (gift tax held "indirect"); *Fernandez v. Wiener*, 326 U.S. 340 (1945) (estate tax on community property held "indirect"). For further examples, see also cases cited in *Bromley v. McCaughn*, 280 U.S. at 136, 137, and *Simmons v. U.S.*, 308 F.2d 160 (4th Cir. 1962).

[38] *Cf, Pollock v. Farmer's Loan and Trust Co.*, 157 U.S. 429 (initial decision), 158 U.S. 601 (on rehearing) (1895) (holding that the income tax is a "direct" tax). Whether or not a tax on "income" is direct or indirect is immaterial to this case, however, for as demonstrated, the "recovery" which Respondent here purports to

(Footnote continued on following page)

those which tax the receipt, transmittal, *use,* or enjoyment of property, as opposed to its mere existence or ownership. In the present case, it is clear that the Petitioner has not *received* any property, nor has it "used" any of its property. Its "recovery" of its overaccrued unpaid losses consists of merely a reduction in the amount of its property which it would otherwise be forced to give up in payment of its claims. The Petitioner's tax burden is increased *not* because it has *received* any property, nor because it has *used* its property in a particular manner. Rather, the Petitioner is being taxed merely because it will *continue* to own a portion of its property, which it had never ceased to own, due to the fact that its actual losses are later proven to be less than its estimated and accrued unpaid losses. In effect, Petitioner is being told, "you must pay tax because you did not lose as much money as you expected to lose."[39] This, Petitioner submits, is a tax on the mere ownership of Petitioner's property, certainly not on its receipt or use, and accordingly

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tax is not "income." In its decision in this case, the Court of Appeals cited *Penn Mutual Indemnity Co. v. Commissioner,* 277 F.2d 16 (3d Cir. 1960) as sanctioning a tax on the gross receipts of insurance companies, without any deduction for losses incurred. The short answer to this argument is that Petitioner does not dispute the constitutionality of a gross receipts tax; as demonstrated earlier, however, the tax in the instant case is imposed in the *absence* of a receipt of any kind.

[39] Of course, had the taxpayer received a prior "tax benefit" (i.e., a reduction in its taxable income) in an earlier year as a result of its accrual of its estimated unpaid losses, taxation of its later recovery of this overaccrual would be authorized, *not* because such recovery is "income" but rather because it constitutes a mere restoration of a tax benefit received, but not deserved, in an earlier year. *See,* note 20, *supra,* and accompanying text. But when the taxpayer has obtained no tax benefit from its earlier accrual of its estimated losses, it is hardly rational to impose a tax merely because not all of those losses are ultimately sustained. Yet this would be the effect of Section 832(b)(5) of the Code as applied by the Court of Appeals.

must be found to be "direct" tax within the meaning of the Constitution.

If in fact the tax in question, as applied under the facts of the instant case, is a "direct" tax, then it is beyond the taxing power of Congress, for it is not apportioned among the states, as required by Article I of the Constitution, and it does not tax "income" as required by the 16th Amendment. Indeed, the three dissenting judges of the Seventh Circuit herein very clearly stated their belief that the tax as applied in the present case was unconstitutional, and they accordingly would have construed and applied the statute to avoid such unconstitutional effect.[40]

Thus this case presents a bona fide question of the interpretation and application of the provisions of the Constitution which impose limits on the taxing authority of Congress, the extent to which that authority is limited by the proscription of unapportioned direct taxes, and the extent, if any, to which Congress' taxing authority would be exceeded under a construction of the statute here at issue in the manner contended for by Respondent (and the Court of Appeals.) We submit that this is a question which it is appropriate for this Court to consider, and accordingly request that the Court exercise its jurisdiction to review the decision of the Seventh Circuit in this regard.

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[40] *See,* Court of Appeals decision on rehearing, slip op. at 6-7 (Fairchild, Pell and Bauer, dissenting) (Appendix A, at A-35, A-36-37). Of course, Petitioner herein does not seek to have the statute declared invalid, but rather seeks only to have it construed in light of the tax benefit rule, according to established principles of statutory construction, to avoid the potential constitutional infirmity.

CONCLUSION

In conclusion, the instant case presents a question of the proper scope and application of a long-established doctrine of income tax jurisprudence, the "tax benefit rule." The decision of the Court of Appeals would effect a drastic and heretofore unanticipated change in that doctrine, which conflicts in principle with the decision of this Court, in *Dobson v. Commissioner, supra,* and with the decisions of various other lower courts. Moreover, the application of the Code Sections here at issue, according to their bare literal terms and without the gloss of the "tax benefit rule", is beyond the taxing power of the Federal government as limited by the Constitution. In light of these factors, we submit that this case is an appropriate one for consideration and review by this Court, and respectfully request that a writ of certiorari issue to review the decision of the Court of Appeals herein.

Respectfully submitted,

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APPENDIX

APPENDIX A
Opinions of the Court of Appeals

United States Court of Appeals

For the Seventh Circuit

Nos. 79-1602 & 79-1603
HOME MUTUAL INSURANCE COMPANY,
Petitioner-Appellee,
Cross-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Repsondent-Appellant,
Cross-Appellee.

Appeal from the United States Tax Court

ARGUED OCTOBER 24, 1979 —
DECIDED APRIL 29, 1980

Before CASTLE, *Senior Circuit Judge,* PELL and TONE, *Circuit Judges.*

TONE, *Circuit Judge.* This case involves two provisions of the Internal Revenue Code concerning the taxation of mutual casualty insurance companies: § 832(b)(5), which allows a "losses incurred" deduction from the companies' underwriting income; and § 821(e), which permits certain companies a "special transitional underwriting loss" deduction from its statutory underwriting income. The issues presented are highly technical and can be adequately stated only after a more detailed description of the statute. The Tax Court ruled in favor of the taxpayer on one issue and in favor of the Commissioner on another. We reverse and remand in part and affirm in part.

Mutual casualty insurance companies, including the taxpayer here, Home Mutual Insurance Company, became subject to §§ 832(b)(5) and 821(d) with the passage of the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960. Before 1963 mutual casualty insurance companies were taxed under a formula that did not include any deduction for underwriting losses or for a special transitional underwriting loss.[1] Beginning with that year, however, these companies have been taxed under a method established by the Revenue Act of 1962, in which a company's taxable income is comprised of three components—taxable investment income, statutory underwriting income, and funds returned from the protection-against-loss account.[2] The statutory underwriting income component consists essentially of underwriting income as it has been computed for non-mutual casualty insurance companies since the 1920's, less a deduction for funds set aside in a protection-against-loss account.[3] Under the decades-old portion of the computation scheme, underwriting income is defined as the amount of premiums earned during the year, less expenses and

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[1] A mutual casualty insurance company paid a federal income tax either at ordinary corporate rates on its investment income or at a rate of one percent on its gross investment income plus its premium income less policyholder dividends, whichever amount was greater. Int. Rev. Code of 1954, ch. 736, §§ 821 & 822, 68A Stat. 260 (amended 1962).

[2] I.R.C. § 821(b); Revenue Act of 1962, Pub. L. No. 87-834, § 8(a), 76 Stat. 960, 989-90. Special provisions not relevant here exist with regard to the taxation of small mutual casualty insurance companies. I.R.C. § 821(c) & (d).

[3] I.R.C. §§ 821(b), 823(a), 824(a), & 832(b); Revenue Act of 1962, Pub. L. No. 87-834, § 8(a) & (c), 76 Stat. 960, 989-90, 992-93; *see* Revenue Act of 1921, ch. 136, § 246(a) & (b), 42 Stat. 227, 262-63. An extra deduction not relevant here was also provided in I.R.C. § 823(a) for companies having gross investment plus premium income of less than $1,100,000.

"losses incurred." I.R.C. § 832(b)(3). The "losses incurred" deduction in turn consists of losses paid during the taxable year netted against cash salvage and reinsurance recoveries, plus any increase (or minus any decrease) during the year in unpaid losses outstanding, minus any increase (or plus any decrease) in salvage and reinsurance recoverable outstanding. I.R.C. § 832(b)(5); Treas. Reg. § 1.832-4(c).[4] The 1962 Revenue Act also provided companies that had experienced underwriting losses during each of the five preceding taxable years with a special transitional underwriting loss deduction to allow them to garner some tax advantage from those recent losses, which had been irrelevant under the prior statute.[5]

The issues before us arose following the Commissioner's assertion of deficiencies in Home Mutual's tax liability for 1966 and 1971 totaling $48,530.71[6] In a petition for a redetermination of the deficiencies, Home Mutual contended, first, that the Commissioner had erroneously failed to allow it during the years 1963-1966 and in 1971 to lower its figure for unpaid losses outstanding at the start of each year by the amount by which pre-1963 claims settled during the year had been overestimated. Such a reduction

[4] To compute the unpaid losses component of the deduction, a taxpayer is to "add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year." I.R.C. § 832(b)(5)(B). Similarly, to take account of salvage and reinsurance recoverable, the taxpayer is to "add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year." I.R.C. § 832(b)(5)(A).

[5] I.R.C. § 821(e); Revenue Act of 1962, Pub. L. No. 87-834, § 8(a), 76 Stat. 960, 991.

[6] The years 1963, 1964, and 1965 are also relevant to the extent that loss carryovers for those years may affect Home Mutual's liability in 1966 and 1971.

would have increased Home Mutual's losses-incurred deduction for those years, thereby decreasing its underwriting income and thus its tax. Alternatively, Home Mutual argued that its exclusion in its original tax returns during 1963-1966 of cash subrogation recoveries from pre-1963 claims was proper because the underwriting losses incurred on those claims had not lessened its taxes.[7] Home Mutual also raised another claim unrelated to the first two, *viz.*, that it should have been allowed to deduct the special transitional underwriting loss from total underwriting gain rather than from underwriting gain less the protection-against-loss deduction.

In a so-called "reviewed opinion," the Tax Court, with one judge dissenting, ruled in favor of Home Mutual on the proper treatment of "unpaid losses," which made it unnecessary to decide the cash subrogation recoveries issue. The court unanimously agreed with the Commissioner on the special transitional underwriting loss issue.[8] The Commissioner appeals the determination of the unpaid loss issue; Home Mutual cross-appeals the Tax Court's interpretation of the special transitional underwriting loss and asks that, if we reverse on the unpaid losses issue, we rule in its favor on the treatment of subrogation recoveries. We reverse the Tax Court's resolution of the unpaid losses dispute, remand the subrogation recoveries issue, and affirm the court's ruling on the special transitional underwriting loss.

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[7] This treatment of subrogation recoveries was the primary basis for the Commissioner's assertion of deficiency.

Subrogation recoveries are included within the meaning of the statutory language of "salvage and reinsurance recoverable" in the computation of the losses-incurred deduction. *See Continental Ins. Co. v. United States*, 474 F.2d 661, 663, 664-65 (Ct. Cl. 1973).

[8] *Home Mutual Ins. Co. v. Commissioner*, 70 T.C. 944 (1978).

I.

Home Mutual's contentions with respect to the unpaid loss deduction are ultimately grounded in the inequity it perceives in the Code's treatment of its overestimate of unpaid losses outstanding as of December 31, 1962. That overestimate, totaling $402,314.59,[9] resulted in smaller "losses incurred" deductions in later years than a totally accurate estimate of unpaid losses would have, because, in every year that some of those claims were settled, the unpaid-losses-outstanding account was decreased not only by the amounts paid on those settlements, which were offset by a corresponding increase in paid losses, but also by the overestimates on the claims.

The similar effect in the years of settlement of post-1962 overestimated losses is more than compensated for by the increase in the unpaid losses part of the losses-incurred deduction that the overestimates cause in the years in which the unpaid losses were incurred. In those years the overestimates increase the "unpaid losses outstanding at the end of the taxable year," I.R.C. § 832(b)(3)(B), and thus the losses-incurred deduction. Accordingly, for years after 1962, overestimating defers taxable income by allowing a company to accelerate its unpaid losses in this manner.

Although Home Mutual cannot obtain a similar acceleration of losses with respect to pre-1963 claims because those losses were then irrelevant to the computation of taxable income, it wishes to avoid the "erroneous" decrease of the deduction in the years it settled overestimated pre-1963 losses. By lowering its "unpaid losses outstanding at the end of the preceding

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[9] This overestimate was 14.74% of the $2,729,746.00 in unpaid losses that Home Mutual reported in its annual statement as of December 31, 1962.

taxable year" by the amounts by which pre-1963 claims settled during the year had been overestimated, Home Mutual argues, it will obtain as a deduction its "true" amount of losses incurred since 1962.

Home Mutual's position can be illuminated by an example. Assume first that the company was notified of a claim in 1963 and estimated that $10,000 would be required to settle the claim. That $10,000 would be added to the unpaid-losses-outstanding account. By raising the balance of unpaid losses outstanding, this addition would increase the losses-incurred deduction from premiums earned to arrive at underwriting income for 1963, thus conferring a tax benefit for that year. The $10,000 would then be carried as an unpaid loss outstanding until paid. Assume the claim is settled in 1965. If the amount of the settlement is $10,000, that amount is removed from unpaid losses outstanding and paid out with no further tax consequences.[10] If, however, the claim is settled for $8000, there are tax consequences in 1965: assuming sufficient income from premiums during the year, the $2000 overestimate is taxed as ordinary income.[11] Now assume that Home Mutual had learned of the claim in 1962, not 1963, and therefore had added the $10,000 to its unpaid losses outstanding in the earlier year. Under the pre-1963 tax scheme, this addition would have had no tax consequences. *See* note 1 *supra*. If the claim is

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[10] In finer statutory detail, the payment of the claim would decrease the balance of unpaid losses outstanding by $10,000, and would increase the amount of losses paid during the year by that amount.

[11] In these circumstances, the balance of the unpaid-losses-outstanding account would be decreased by $10,000 while the amount of losses paid would be augmented by only $8000. Thus, the losses-incurred deduction would be reduced by $2000.

If there is not sufficient premium income, the $2000 would reduce the unused loss deduction provided by § 825 eligible for carrybacks and carryovers.

then settled for $8000 in 1965, the company, under the literal terms of the statute, would have to pay tax on the $2000 overestimate in 1965 as above. While in the first instance the taxation of the $2000 occurs only after a company has received a corresponding tax benefit in 1963 by including that amount in the losses-incurred deduction for that year, in the second case taxation of the $2000 would occur despite the absence of such a prior tax benefit. As a remedy, Home Mutual wishes, in computing its taxes for 1965, to lower its unpaid losses outstanding at the beginning of 1965 by $2000 and thereby prevent its inclusion in taxable income in that year.[12]

Home Mutual's argument is made in the context of comprehensive, technical, and very specific provisions of the Internal Revenue Code. Especially when dealing with provisions of this kind, and when no support for the theory asserted by the taxpayer can be found in the language of the statute, the appurtenant regulations, or the legislative history, the courts should ordinarily "resist the temptation to attempt any creative rewriting of the Internal Revenue Code."[13]

There is nothing in the statutory provision involved in the case at bar, its regulations, or its legislative history revealing even a glimmer of any intent that Home Mutual would be allowed to make the retroactive adjustment it wishes. The statutory formula for computing the losses-incurred deduction was first enacted in § 246(b)(6) of the Revenue Act of 1921, ch. 136, 42 Stat. 227, 263, for use in taxing stock casualty insurance companies and has been reenacted since

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[12] Thus, the net decrease in the balance of unpaid losses outstanding during 1965 would be only $8000, offsetting exactly the increase in the amount of losses paid.

[13] *United States v. Foster Lumber Co.*, 429 U.S. 32, 49 (1976) (Stevens, J., concurring).

then without substantial change. As the Tax Court pointed out, "[t]he 1962 Act was designed to tax the mutual companies on much the same basis as the stock companies." 70 T.C. at 945-46. The first regulations concerning the losses-incurred deduction, which were adopted in 1944, expressly recognized that the unpaid-losses-outstanding component of the deduction is an estimate of the total amount of losses incurred but unpaid at year's end.[14] Given the longstanding existence of these regulations interpreting a statutory provision that has remained unchanged, they are deemed to have received congressional approval and have the effect of law. *See United States v. Correll,* 389 U.S. 299, 305-06 (1967); *Hanover Insurance Co. v. Commissioner,* 598 F.2d 1211, 1219 n.17 (1st Cir.), *cert. denied,* 100 S. Ct. 229 (1979). In addition, the casualty insurance industry has adapted its own reporting forms for use under the regulations, so that the forms now serve as the basis on which a company's income is determined. *See Hanover Insurance Co. v. Commissioner,* 65 T. C. 715, 720-21 (1976);[15] *Continental Insurance Co. v. United States,* 474 F.2d 661, 666-67 (Ct. Cl. 1973). Since the unpaid losses component of the losses-incurred deduction is merely an estimate, the only allowable adjustment by either the Commissioner or taxpayer would be to correct a figure that was not a "fair and reasonable" estimate given the facts at the time the estimate was

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[14] Treas. Reg. 111 § 29.204-2, 1944 C.B. 336-37 (recodified as Treas. Reg. 118, § 39.204-2(a) & (b), 26 C.F.R. § 39.204-2(a) & (b) (1953 ed.) by Revenue Ruling 53 226, 1953-2 C.B. 500); *see also* Treas. Reg. § 1.832-4(a)(5) & (b).

[15] In *Hanover Ins. Co. v. Commissioner,* 65 T.C. 715 (1976), the Tax Court denied Hanover's motion to dismiss. An appeal of that decision was dismissed. The Tax Court then rendered an opinion on the merits at 69 T.C. 260 (1977), which was affirmed by the First Circuit in the opinion at 598 F.2d 1211, which we also cite in our opinion.

made. *See Hanover Insurance Co. v. Commissioner,* 598 F.2d 1211 (1st Cir.), *cert. denied,* 100 S. Ct. 229 (1979); Treas. Reg. § 1.832-4(b).[16] Home Mutual admits that no legislative history of the 1962 Revenue Act supports its attempt to go outside the language of the statute. In light of this absence of statutory support for the adjustment desired by Home Mutual, only the existence of a principled extra-statutory ground for adjustment could persuade us to go beyond the express bounds of the statute.

We consider in turn two theories that have been advanced to support the adjustment Home Mutual seeks. The Tax Court majority's theory, which Home Mutual does not attempt to support in this court, was that the adjustment is analogous to permissible retroactive adjustments of inventories and also to the adjustment of bad debt reserve permitted by Revenue Ruling 58-126, 1958-1 C.B. 13. Home Mutual presents an argument that the Tax Court appeared to reject, that the tax benefit rule allows such an adjustment. We are not persuaded by the reasoning of the Tax Court majority or Home Mutual.

A.

In each of the cases the Tax Court majority believed analogous, a taxpayer has been allowed to adjust the value of opening inventory (the closing

[16] Home Mutual argues that the Commissioner's power under *Hanover Insurance Co.* to adjust a taxpayer's unpaid losses outstanding retroactively and his policies allowing retroactive adjustment by his auditors are authority for allowing Home Mutual to adjust its unpaid losses retroactively in light of what was actually paid. However, the Commissioner's authority is limited to the retroactive adjustment of an original estimate that, given the facts and circumstances at the time, was not a fair and reasonable estimate; that authority does not permit the Commissioner, or Home Mutual, to adjust an estimate retroactively so as to equal the amount later actually paid.

inventory of the preceding year) after its original calculation. *See, e.g., Elm City Nursery Co. v. Commissioner,* 6 B.T.A. 89 (1927), *acq.,* VI-2 C.B. 2; *Baumann Rubber Co. v. Commissioner,* 4 B.T.A. 671 (1926). These adjustments have, however, served only to correct errors in reporting facts ascertainable at the time of the original calculation. In *Baumann Rubber Co.* the taxpayer had incorrectly counted the items in the inventory, an error that was later discovered and that the Board of Tax Appeals allowed the taxpayer to correct. In *Elm City Nursery Co.* the value of the inventory had been ascertainable, but the taxpayer had deliberately inflated the figures for the purpose of borrowing funds. When the taxpayer demonstrated that the actual inventory value had been less, the Board of Tax Appeals allowed the taxpayer to reduce its inventory figures accordingly and arrive at an accurate amount for cost of goods sold.

In the case at bar, however, taxpayer is not attempting to adjust its unpaid losses outstanding to an amount that could have been determined from facts existing at the time of the original estimate. Strictly analogous to those cases in this situation would be a showing by taxpayer that, given the facts existing at the end of the year preceding the taxable year, its estimate of unpaid losses was unreasonable. *See Hanover Insurance Co. v. Commissioner,* 598 F.2d 1211 (1st Cir.), *cert. denied,* 100 S. Ct. 229 (1979). Instead, Home Mutual here wishes to change the estimate of an unpaid loss to the amount actually paid to settle that particular claim. Courts have not permitted taxpayers to make inventory adjustments because of subsequent events. *See Estate of Stauffer v. Commissioner,* 48 T.C. 277 (1967), *rev'd on other grounds,* 403 F.2d 611 (9th Cir. 1968).

This reasoning has the additional defect of not being limited in principle to application to the

estimates of unpaid losses incurred prior to 1963. The estimate of an unpaid loss incurred in 1965, for instance, could also prove to be higher than the actual amount of a settlement ultimately reached in a later year. However, nothing in this theory would prevent the taxpayer from reducing its opening unpaid-losses-outstanding account for the year of settlement by the amount of the overestimate and thereby change the deferment of income contemplated by the congressional scheme into an outright exemption.[17] Such a rationale plainly cannot be accepted.

Likewise unpersuasive is the analogy to Revenue Ruling 58-126, which permitted a savings and loan association that first became subject to taxation in 1952 to transfer the amount by which its pre-1952 loss reserve was found to be excessive from the reserve to its undivided profits without producing gross income.[18] Although the loss reserve of a savings and loan association is similar to a mutual casualty insurance company's unpaid loss account, the Code provisions allowing the two deductions are structured differently. A loss reserve is merely a method of utilizing the bad debt deduction. A taxpayer may deduct worthless debts in the year they become worthless pursuant to § 166. Alternatively, under § 593 a taxpayer may deduct a reasonable amount each year to be set aside to cover

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[17] Exemption would result because the increase in the losses-incurred deduction in the year that a loss is incurred is never counterbalanced later by a decrease in the deduction in the year in which the loss is paid. *See* text at notes 9-12 *supra*.

[18] The Revenue Ruling also decided that any such transfer that lowered the loss reserve below the aggregate amount of post-1951 additions to the reserve deducted for federal income tax purposes, minus charge-offs for bad debt losses after 1951, and plus recoveries on debts charged to the reserve after 1951 would result in gross income to the extent of the diminution.

worthless debts generally.[19] When specific debts do become worthless, they are charged off against the reserve with no direct tax consequences.[20]

In similar fashion a mutual casualty insurance company will set aside funds it estimates are necessary to cover pending claims.[21] The Code, however, does not treat these funds as a § 593 loss reserve. If it did, a taxpayer would have a choice: either it could deduct specific losses when they accrue or are paid or it could deduct a reasonable amount each year as an addition to a reserve and merely charge off against the reserve all losses when actually paid. Instead, a taxpayer has no choice; only one statutory method exists for deducting underwriting losses of mutual casualty insurance companies. Under that method, when a loss is "incurred" through the assertion of a claim but not paid during the year, the

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[19] Taxpayers eligible for use of reserves for losses on loans include mutual savings banks not having capital stock represented by shares. I.R.C. § 593(a).

The amount a taxpayer may set aside is subject to various statutory and regulatory limitations. I.R.C. § 593(b); Treas. Reg. § 1.593.

The Tax Reform Act of 1969 enacted § 585, a provision parallel to § 593 that is available to banks not eligible under § 593 and to certain other financial institutions. Tax Reform Act of 1969, Pub. L. No. 91-172, § 431(a), 83 Stat. 487, 616-18.

[20] The actual charging off of a bad debt does have indirect tax consequences. In 1958, when Revenue Ruling 58-126 was issued, the amount of a deductible addition to a reserve was limited to the lesser of —

(1) the amount of its taxable income for the taxable year, computed without regard to this section, or

(2) the amount by which 12 percent of the total deposits or withdrawable accounts of its depositors at the close of such year exceeds the sum of its surplus, undivided profits, and reserves at the begining of the taxable year.

(Footnote continued on following page)

estimated amount thereof is added to the unpaid-losses-outstanding "reserve"; in the later year in which the claim is actually paid, the amount of the estimate is subtracted from unpaid losses outstanding and the amount of the payment is added to losses paid. Another contrast with the § 593 reserve is that none of the losses actually paid during a taxable year is merely charged off against a reserve. All losses paid, including those from prior years that have been carried as part of the unpaid-losses-outstanding "reserve," are added into the losses-incurred deduction.[22] Another difference between the two statutory mechanisms is the different significance attached to changes in the reserve. The only change in a § 593 reserve with direct tax consequences is the addition of a reasonable amount during the year; the actual payment of a loss is charged off against the reserve but has no direct tax consequences. In contrast, all modifications of an unpaid-losses-outstanding reserve

Int. Rev. Code of 1954, ch. 736, § 593, 68A Stat. 205. Because the balance of the reserve at the beginning of the taxable year was relevant to computation of the second alternative ceiling, the charging off of a bad debt, by lowering the balance of the reserve, increased the ceiling for permissible additions in subsequent years. Although current provisions placing a ceiling on the amount a taxpayer may add to a reserve are much more complicated, the effect of charging off a bad debt (or crediting recovery of an earlier bad debt) is much the same. Section 585(b)(2) and § 585(b)(3), relevant through § 593(b)(3) and § 593(b)(1)(A) respectively, establish two potential ceilings on the deduction permissible for an addition to a bad debt reserve. In both, the charging off of bad debts (and the crediting of recoveries) during prior years and the taxable year are relevant to computation of the ceilings. I.R.C. § 585(b)(2) & (3)(A).

[21] However, while additions are generally made to a loss reserve without any evaluation of the likelihood that particular debts will soon become worthless, more than 95% of Home Mutual's unpaid losses outstanding on December 31, 1962 consisted of estimates of the amounts necessary to pay particular claims.

directly affect the amount of a taxpayer's deduction for losses incurred. Indeed, if the balance of the unpaid-losses-outstanding reserve decreased over the course of the taxable year, the losses-incurred deduction itself is diminished for that year.

The differing structures of the statutory schemes directly affect the issue under consideration here. Under the provisions of the statute relevant in Revenue Ruling 58-126, the loss reserves accumulated before 1952 were irrelevant to computation of the savings and loan association's income beginning that year.[23] In contrast, the express terms of § 832(b)(5) make the amount of the unpaid losses outstanding estimated for pre-1963 claims relevant in determining taxable income after 1962. Thus, while savings and loan association income set aside in a loss reserve when that income is not taxable may not be taxed if returned to undivided profits in a year in which income of a like kind is taxed, that result does not compel the conclusion that we should interpret a different statutory scheme as allowing Home Mutual to adjust its estimate of pre-1963 claims at the beginning of a taxable year according to the actual amounts paid during that year.

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[22] This procedure does not result in a double deduction for a loss included in prior years as part of unpaid losses outstanding. In the year of payment, the amount paid becomes part of "losses paid" and thus increases the losses-incurred deduction. Yet at the same time, the balance of "unpaid losses outstanding" is decreased by the amount of the estimated loss included earlier in the account for that claim, effectively reducing the deduction by that amount. If the actual payment of a claim equals the earlier estimate, the procedure results in a complete washout, the addition to the losses actually paid being exactly counterbalanced by the decrease in the unpaid losses outstanding.

[23] Revenue Ruling 58-126 has thus been explained in Rev. Rul. 73-273, 1973-1 C.B. 79.

Further support for our conclusion is provided by *Pacific Mutual Life Insurance Co.*, 48 T.C. 118 (1967), *rev'd on other grounds*, 413 F.2d 55 (9th Cir. 1969), and *Lutheran Mutual Life Insurance Co. v. United States*, 602 F.2d 328 (Ct. Cl. 1979), *petition for cert. filed*, 48 U.S.L.W. 3570 (U.S. Feb. 23, 1980), which concerned questions very similar to the one before us that arose under taxing mechanisms enacted in the Life Insurance Company Income Tax Act of 1959 that were, unlike the bad debt mechanism discussed above, very similar to the one here. Both cases involved efforts by taxpayers to lower their opening reserves to reflect actual experience during the years and thus avoid hardship attending Congress' imposition of a new taxing formula. Although the courts differed somewhat in their evaluation of legislative history common to both cases, both agreed that the explicit language of the statute precluded adjustment of a reserve that, in the words of the court in the *Pacific Mutual* case, "at the time it was established, was based upon all available information and contained no mathematical error." 48 T.C. at 129.[24] The same result must be reached at bar, where there is no legislative history that even arguably supports the taxpayer's position.

B.

Home Mutual argues that we should affirm the Tax Court on this issue on the basis of the tax benefit

[24] The Tax Court also held that, even if the statute would allow an adjustment, Pacific Mutual had not in fact proved the ultimate amount of its liablities on pre-1958 claims and thus that its opening reserves for 1958 were overestimated. *Id.* at 129-31. The Tax Court in the case at bar and Home Mutual both attempt to distinguish *Pacific Mutual* on the grounds that Home Mutual has proved that its opening reserves in 1963 were overstated. However, "where a decision rests on two or more grounds, none can be relegated to the category of *obiter dictum.*" *Woods v. Interstate Realty Co.*, 337 U.S. 535, 537 (1949).

rule and allow reduction of unpaid losses outstanding at the beginning of each taxable year by the amount by which amounts actually paid that year on pre-1963 claims fell below original estimates. The tax benefit rule is a well established judge-made rule[25] that despite partial codification in § 111 remains substantially extra-statutory in nature and affects a taxpayer's taxable income beyond the literal meaning of the Code itself. Thus it is not sufficient to rebut the invocation of the tax benefit rule to argue that the statute makes no provision for its use here or to cite *Pacific Mutual* and *Lutheran Mutual,* where the tax benefit rule was not considered. Upon examining the contours of the tax benefit rule itself, however, we conclude that it does not apply in this case.

The tax benefit rule is "both a rule of inclusion and exclusion: recovery of an item previously deducted must be *included* in income; that portion of the recovery not resulting in a prior tax benefit is *excluded.*"[26] Until 1929 it was unclear, in light of *Eisner v. Macomber's* definition of income as "gain derived from capital, from labor, or from both combined," whether a taxpayer was required to report recoveries of funds owed to it that had previously been deducted.[27] Although various justifications have been

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[25] *See First Trust & Savs. Bank of Taylorville v. United States,* 614 F.2d 1142, 1144 & n.2 (7th Cir. 1980).

[26] *Putoma Corp. v. Commissioner,* 66 T.C. 652, 664 n.10 (1976), *aff'd,* 601 F.2d 734 (5th Cir. 1979) (emphasis in original.) See *Bittker & Kanner, The Tax Benefit Rule,* 26 U.C.L.A. L. Rev. 265, 267-72 & n.20 (1978). The tax benefit rule is not limited to the recoveries of deductions. It also covers recoveries of items that had earlier resulted in tax credits and of funds, such as embezzled monies, that were never included in gross income. *See California & Hawaiian Ref. Corp. v. United States,* 311 F.2d 235, 238 n.1 (Ct. Cl. 1962); 1 J. Mertens, *The Law of Federal Income Taxation* § 7.34, at 114 (rev. ed. 1974).

[27] *Eisner v. Macomber,* 252 U.S. 399, 415 (1920). *See* Bittker & Kanner, *supra* note 26, at 266.

offered for requiring taxpayers to report funds received from what normally is not viewed as an income-producing event, perhaps the best is that the inclusionary aspect of the tax benefit rule counterbalances the annual accounting principle enunciated in *Burnet v. Sanford & Brooks,* 282 U.S. 359 (1931). A taxpayer should not be permitted to take advantage of the tax system's need to treat transactions as final at the end of the accounting year so that tax consequences can be calculated. The rule allows accurate taxation of a whole transaction that may span several accounting periods.[28] In short, the inclusionary aspect of the rule, which is based entirely on case law,[29] "recognizes the 'recovery' in the current year of taxable income earned in an earlier year but offset by the item deducted."[30] Because such recoveries are reportable due to the existence of previous deductions, taxpayers have successfully argued that the recoveries should be included in income only to the extent that the earlier deduction had in fact served to reduce its taxable income in the year in which the deduction was taken. This exclusionary aspect of the tax benefit rule was not conclusively accepted until 1942, when Congress enacted the statutory predecessor to current § 111.[31] Although § 111 expressly provides for such exclusion only for the recovery of previously deducted bad debts, taxes, and delinquency amounts, it is well settled that this aspect of the tax benefit rule extends

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[28] *See* Bittker & Kanner, *supra* note 26, at 267-70.

[29] *See* 1 J. Mertens, *supra* note 26, § 7.34, at 111.

[30] *Munter's Estate v. Commissioner,* 63 T.C. 663, 678 (1975) (Tannenwald, J., concurring).

[31] *See* Bittker & Kanner, *supra* note 26, at 271; 1 J. Mertens, *supra* note 26, § 7.34, at 111-12 n. 40; *California & Hawaiian Sugar Ref. Corp. v. United States,* 311 F.2d 235, 238 n.3 (Ct. Cl. 1962).

beyond the literal terms of the statute.[32] Thus, although the exclusionary part of the tax benefit rule finds a statutory anchor, the entire rule remains in essence an extra-statutory judicial rule permitting retroactive adjustments so that some transactions substantially altered in years subsequent to the original accounting period may be taxed virtually as though the entire transaction had occurred in one accounting period.[33]

Home Mutual invokes the tax benefit rule's exclusionary aspect in its argument that it should not be required to reduce its losses-incurred deduction by the amount of its overestimation of its pre-1963 claims paid later. According to Home Mutual, when the company receives notice of a claim against one of its policies, its estimate of the amount necessary to cover the claim is entered as an accrued liability and, after 1962, effectively deducted as a "loss incurred" under § 832(b)(5). If in a later year a lesser amount satisfies the claim, the company "recovers" the amount by which it overestimated the claim, restores the amount of this "overaccrual" to its earned surplus, and pays tax on

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[32] *See* Bittker & Kanner, *supra* note 26, at 266-67, 271; 1 J. Mertens, *supra* note 26, § 7.34, at 112-14 & nn. 42.1-44, & § 7.37, at 124-25; *Dobson v. Commissioner,* 320 U.S. 489 (1943); *California & Hawaiian Sugar Ref. Corp. v. United States,* 311 F.2d 235, 238-39 (Ct. Cl. 1962); *Home Savings & Loan Co.,* 39 T.C. 368, 370 (1962), *acq.,* 1963-2 C.B. 4, 1965-2 C.B. 5; *Birmingham Terminal Co.,* 17 T.C. 1011, 1014 (1951), *acq.,* 1952-1 C.B. 1; *M & E Corp.,* 7 T.C. 1276 (1946), *acq.,* 1947-1 C.B. 3. *See also* Treas. Reg. § 1.111-1(a).

[33] Because recoveries are treated as income in the year recovered rather than in the year originally deducted and because marginal tax rates vary with the amount of other income, the tax benefit rule is not likely to result in taxpayer paying precisely the same amount of extra tax in the year of recovery as the amount of tax saved by the earlier deduction. *See* Bittker & Kanner, *supra* note 26, at 270-71; 1 J. Mertens, *supra* note 26, § 7.37, at 129-30.

this amount as income, again through the workings of § 832(b)(5). *See* text at notes 10-12 *supra*.

The fact that the deduction occured by means of a bookkeeping accrual and recovery by a mere reversal of that accrual, with the money never leaving the taxpayer's coffers, does not preclude the application of the tax benefit rule. [34] Tax benefit principles, if not the rule itself, have been held to apply to the release of funds from reserve accounts.[35]

Similarly, it is not critical to the applicability of the tax benefit rule that, because the amount of Home Mutual's underwriting losses was not relevant under the statute before 1963, no deduction was ever taken for pre-1963 unpaid losses incurred. Although the strict language of § 111 requires that a taxpayer have taken a deduction or credit before it may show that that deduction or credit produced no benefit and exclude the recovery from income, it has been held that taxpayers completely exempt from federal income taxation at the time the expense was taken are eligible for tax benefit treatment.[36] Thus prior expenses not taken as deductions or credits because entirely irrelevant to the computation of taxpayer's taxable income would seem eligible for tax benefit treatment.

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[34] *See Lime Cola Co.*, 22 T.C. 593 (1954), *acq.*, 1955-2 C.B. 7; *M & E Corp.*, 7 T.C. 1276 (1946), *acq.*, 1947-1 C.B. 3; 1 J. Mertens, *supra* note 26, § 7.37, at 128 & n.82 & 130.

[35] *See Maryland Casualty Co. v. United States*, 251 U.S. 342, 352 (1920) (dictum) (inclusionary aspect); *Dallas Title & Guaranty Co.*, 40 B.T.A. 1022, 1028-32 (1939), *rev'd on other grounds*, 119 F.2d 211 (5th Cir. 1941) (inclusionary aspect); *M & E Corp.*, 7 T.C. 1276 (1946), *acq.*, 1947-1 C.B. 3 (exclusionary aspect). *Dallas Title* also excluded released reserves from income to the extent they represented prior deductions that, although benefitting taxpayer, were improper.

[36] *See Home Savings & Loan Co.*, 39 T.C. 368 (1962), *acq.*, 1963-2 C.B. 4, 1965-2 C.B. 5; *California & Hawaiian Ref. Corp. v. United States*, 311 F.2d 235, 237-40 (Ct. Cl. 1962).

On the basis of these principles, Home Mutual argues that, because the funds set aside to cover the claim provided it with no tax benefit, their transfer to earned surplus is not subject to tax under the exclusionary aspect of the tax benefit rule.[37]

More is required, however, for application of the tax benefit rule. Home Mutual wishes us to apply the exclusionary aspect of the tax benefit rule even though the rule has had no role in ensuring that the "recoveries" are taxed. In the cases we have examined, with the possible exception noted in the margin,[38] the exclusionary aspect of the tax benefit rule becomes relevant only after the Commissioner has employed the inclusionary aspect of the rule to include in gross income recoveries that according to the strict terms of the statute are not income.[39] The historical origin of the rule noted above supports an interpretation of the rule that requires use of the inclusionary aspect of the

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[37] Alternatively, Home Mutual argues that the funds set aside were actually earned by the company prior to 1963 and thus should not be subjected to taxation now. To this contention we think it a sufficient answer to say that, absent a well established judge-made exception, the Code itself, as amplified by its regulations, determines what is taxable income.

[38] One recent Tax Court judge has applied the exclusionary aspect of the tax benefit rule to the treatment of salvage and subrogation recoveries under § 832(b)(5). In *American Financial Corp. v. Commissioner,* 72 T.C. 506 (1979), taxpayer, a stock casualty insurance company taxed during the entire relevant period on a cash basis accounting method under the same provisions that have applied to Home Mutual since 1962, claimed losses-incurred deductions in various years prior to 1960. Because of net operating losses subsequently incurred and the expiration of net operating loss carryovers relating to the pre-1960 years, these deductions ultimately resulted in no tax benefit for taxpayer. In 1966, taxpayer received various salvage and subrogation proceeds related to these pre-1960 claims, which it did not include in its computation of losses incurred on the grounds that they should be excluded under

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rule before a taxpayer can employ the exclusionary aspect. The inclusionary aspect of the tax benefit rule does not come into play in the situation at bar. "Recoveries" of the amounts of overestimates of actual liability on unpaid losses are taxed not by operation of the tax benefit rule to make such recoveries items of gross income under § 61(a), but by the specific terms of a detailed statutory mechanism, which requires downward adjustment of a taxpayer's unpaid losses outstanding at the end of the year during which the claim is actually paid by the amount of the original estimate. *See* text at notes 10-12 *supra*.[40] Thus the case at bar does not fall within the established scope of the tax benefit rule. In light of the principle inhibiting creative judicial rewriting of the statutory language, *see* text at notes 13-14 *supra*, we decline to expand the tax benefit rule to allow Home Mutual to go beyond the literal terms of this statute and retroactively adjust

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§ 111. In the course of ruling in favor of taxpayer, Judge Dawson rejected the Commissioner's argument that § 111 was inapplicable because such recoveries were not items of income in the statutory scheme, but merely offsets to the deduction for losses incurred. Judge Dawson concluded that accepting the Commissioner's theory could lead to "absurd and unintended results." 72 T.C. at 514. In a year in which a cash basis taxpayer received more in salvage recoveries than it paid in claims, the Commissioner's theory would prevent inclusion of this excess in taxpayer's gross income. Noting that "[s]ection 832(b)(5) does not provide that salvage can be used *only* as an offset," *id.* (emphasis added), Judge Dawson thought it unlikely that the Commissioner would fail to invoke the inclusionary aspect of the tax benefit rule in that case. Putting technical niceties aside, Judge Dawson concluded that salvage and subrogation recoveries were items of gross income and the tax benefit rule applied.

For the reasons stated in the text, we believe the use of the exclusionary aspect of the tax benefit rule to be improper in the case at bar. We are not persuaded to the contrary by the reasoning of *American Financial Corp.* While § 832(b)(5) arguably does not

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its unpaid losses outstanding at the beginning of a taxable year by the amount by which it had originally overestimated its ultimate liability on claims paid during the year.

II.

In the alternative, Home Mutual argues that it need not include any cash salvage and subrogation recoveries made on pre-1963 claims. Home Mutual concedes that the literal language of the statute and regulations would require such inclusion,[41] but argues that the tax benefit rule allows exclusion of these recoveries from the computation of the losses-incurred deduction because they relate to losses from which Home Mutual derived no tax benefit. It cites *American Financial Corp. v. Commissioner*, 72 T.C. 506 (1979), in support of its position. Although we are not persuaded

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prohibit the Commissioner from including the excess of salvage recoveries over paid claims in gross income on the basis of the tax benefit rule, we believe that the exclusionary aspect of the rule may properly be invoked only to that extent. Indeed, the facts of *American Financial Corp.* themselves reinforce our conclusion. Application of the tax benefit rule's exclusionary aspect years after the expiration of the loss carryovers effectively allows taxpayer to offset recoveries that by the terms of the statute and regulations, not by application of the tax benefit rule, should increase income. Use of the tax benefit rule would, in effect, abrogate the statutory limitation prohibiting a taxpayer from carrying forward net operating losses indefinitely and allow a taxpayer to revive long-expired deductions in the year of recovery.

[39] *Home Savings & Loan Co.*, 39 T.C. 368 (1962), *acq.*, 1963-2 C.B. 4, 1965-2 C.B. 5, is in accord with this analysis. The taxpayer, exempt from federal income taxation until 1952, received refunds in 1956 for state property taxes improperly collected from 1947 through 1951. Although the Commissioner attempted to include the refunds in income as an item of gross income solely by means of a bald assertion of I.R.C. § 61(a), the Tax Court indicated that the recoveries could be included as income only under the inclusionary

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by the relevant reasoning in that case, *see* note 38 *supra,* possible grounds exist for distinguishing between the unpaid losses issue and the cash subrogation recoveries issue. For instance, because no explicit statutory basis exists for the regulation requiring the subtraction of cash salvage and reinsurance recoveries from paid losses in the computation of the losses-incurred deduction, it is arguable that the only authority for the regulation is the inclusionary aspect of the tax benefit rule. If the tax benefit rule is the ultimate authority for requiring that cash recoveries be used to increase a taxpayer's taxable income, it might be appropriate to allow a taxpayer to invoke the rule's exclusionary aspect. At oral argument counsel for the Commissioner admitted that the cash subrogation recoveries issue was a closer question than the unpaid

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aspect of the tax benefit rule, quoting and citing *Perry v. United States,* 160 F.Supp. 270 (Ct. Cl. 1958), an inclusionary tax benefit rule case. Because the state taxes, when paid, produced no tax benefit, the court then concluded that the exclusionary aspect also applied.

[40] Under the statutory mechanism, some recoveries that might be included in gross income under tax benefit principles are not taxed at all. If salvage recoveries for a cash basis taxpayer exceed its losses paid during the year, that excess is not taxed. *See American Financial Corp., supra* note 38, 72 T.C. at 514. Similarly, under the simplifying assumption that no other unpaid losses accrue or are paid during the year, the amount by which the sums paid during the year to settle overestimated pre-1963 claims exceed the sum of paid losses (after subtracting cash salvage and reinsurance recoveries) and the decrease in salvage and reinsurance recoverable is not taxed even though that excess represents funds released for general use by the taxpayer. Only if the Commissioner attempts to include these excesses in a taxpayer's gross income through use of the tax benefit rule may taxpayer use the exclusionary aspect of the rule.

losses issue.[42] Because of the absence of prior Tax Court consideration of these complexities in the case at bar, we remand this issue to that court for its consideration.

III.

In an argument independent of its first two, Home Mutual contends that it should have been permitted to deduct the special transitional underwriting loss provided by § 821(e) from the total underwriting gain rather than from underwriting gain less the protection-against-loss deduction allowed by § 824(a). Home Mutual argues for this result on the grounds that the relevant statutory provisions are in irreconcilable conflict and that the legislative history of § 821(e) shows it to be remedial legislation, which must be broadly construed to effectuate its purpose. We find no irreconcilable conflict but merely a statutory scheme that does not by its terms allow Home Mutual as much benefit from its special transitional underwriting loss as it would like.

The special transitional underwriting loss allowed by § 821(e) is a special reduction in the "statutory underwriting income" of any mutual casualty insurance company that was taxable for the five taxable years preceding January 1, 1962 under § 821 as it existed before the 1962 Revenue Act and that sustained an underwriting loss in each of those five years. In

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[41] Strictly speaking, Treasury Regulation § 1.832-4(c), and not the statutory provisions themselves, make cash salvage and subrogation recoveries relevant to the computation of the losses-incurred deduction by requiring them to be subtracted from losses paid during the taxable year.

[42] In addition, in his main brief before this court, the Commissioner suggested that we remand this issue if its resolution became necessary for decison of this case.

any taxable year between 1963 and 1967 inclusive, a company can use the aggregate of these underwriting losses, to the extent not used before under this subsection, to offset its statutory underwriting income. After the company's 1967 taxable year, any unused special transitional underwriting loss expires. For purposes of § 821(e), "statutory underwriting income" is defined in § 823(a)(1). Treas. Reg. § 1.821-5(a). That section specifies that. to compute statutory underwriting income, one must subtract the deduction provided by § 824(a) for the amount added to the protection-against-loss account. Thus under the clear statutory language, Home Mutual is entitled to deduct its special transitional underwriting loss only after the protection-against-loss deduction has been taken.

Home Mutual argues, however, that § 821(b)(1)(C) and § 824(d) create an irreconcilable conflict. The latter section mandates that certain subtractions be made each year from the protection-against-loss (PAL) account. Under some circumstances the entire amount of the PAL deduction added to the account under § 824(b) will immediately be subracted from the account under § 824(d). Section 821(b)(1)(C) requires that the total amount subtracted from the PAL account under § 824(d) be included in a mutual insurance company's taxable income. Thus the PAL deduction granted from the company's statutory underwriting income for a year may effectively be taken away that same year through the add-back requirement of § 821(b)(1)(C). Under the terms of the statute explained in the preceding paragraph the company may not use the special transitional underwriting loss to offset the amount of the PAL deduction added back to income but must employ the unused loss carryovers and carrybacks provided by § 825. Because of this limitation Home Mutual had to employ part of its unused loss carryovers available through 1968 and 1969.

rather than part of its special transitional underwriting loss expiring after 1967, to offset the amount of the PAL deduction added back to income in 1965 and 1966. Home Mutual was left with unused, expired special transitional underwriting loss of $217,117.31 that could otherwise have offset this income and loss carryovers for 1968 and 1969 that were correspondingly depleted.[43] Citing legislative history showing generally that § 821(e) was remedial legislation, Home Mutual argues that the special transitional underwriting loss should be available to offset statutory underwriting income after a "net" PAL deduction computed after the implementation of § 824(d). Only in this way, according to Home Mutual, can conflicting provisions be reconciled so as to give Home Mutual full use of its special transitional underwriting loss, in harmony with the remedial purpose of § 821(e).

We perceive no irreconcilable conflict in this statutory scheme. Home Mutual is not caught in a maze of conflicting statutory demands with no exit. There is an exit, just not one to Home Mutual's liking. The PAL deduction is added back to income, but as an element totally separate from statutory underwriting income. Congress established the protection-against-loss account in recognition of mutual casualty insurance companies' lack of access to the capital market for funds with which to pay losses. Section 824 allows companies to set aside part of their underwriting gain each year, which would otherwise be taxed, in a special account for protection against losses. The bulk of the funds is set aside for a period as

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[43] Home Mutual's original special transitional underwriting loss totaled $936,698.29. Under Home Mutual's method, it would have used $450,364.68 before its expiration after 1967. Under the Commissioner's computation method, only $233,247.37 would have been used.

long as five years until needed to pay losses. All the gain set aside will eventually be taxed, but the tax is deferred until the funds are used to cover losses or until the five-year period expires. Section 824(d) serves as the detailed formal mechanism for withdrawal of money from the account as losses occur during those five years, for establishment of a ceiling on the total amount set aside at one time, and for return of most of the unused funds to earned surplus after the five-year period. *See* S. Rep. No. 1881, 87th Cong., 2d Sess. 54-55 (1962), *reprinted in* [1962] U.S. Code Cong. & Ad. News 3297, 3357-58 *and* 1962-3 C.B. 703, 760-61; H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962), *reprinted in* 1962-3 C.B. 402, 446-47; *see also* 8 J. Mertens, *The Law of Federal Income Taxation* § 44.58a, at 209-11 (rev. ed 1978.) Thus the amount of underwriting gain removed to the protection-against-loss account becomes a special category of income on which taxation is deferred. That the financial performance of a company in a particular taxable year may require that the amount removed from that year's underwriting gain be used, in effect, to cover losses of the same year does not transform those funds back into statutory underwriting income. The statutory scheme is both clear and comprehensible.[44]

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[44] One specific argument of conflict results from a potential ambiguity in the calculation of the PAL deduction created by the language of § 821(e)(2). That subsection states that "the statutory underwriting income of a company [eligible for the special transitional underwriting loss] shall be the statutory underwriting income for the taxable year ... reduced by [the special transitional underwriting loss]." Section 824(a)(1), which provides that a part of the PAL deduction is a percentage of underwriting gain, defines underwriting gain as "statutory underwriting income, computed without any deduction under this subsection." Thus, one could argue, as Home Mutual apparently does, that its statutory underwriting income for purposes of calculating the PAL deduction is the amount resulting after deduction of the special transitional

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Home Mutual cites legislative history to show that enactment of § 821(e) was intended as a remedial measure. That it was, and Home Mutual has benefitted from its use. However, that legislative history does not permit us to ride roughshod over the statutory language and provide greater benefit to a taxpayer than that provided by the terms of the statute itself.

Pursuant to Rule 39(a) and (b) of the Federal Rules of Appellate Procedure,[45] the costs of this appeal will be taxed against Home Mutual. The decision of the Tax Court is hereby affirmed in part, reversed in part, and remanded in part.

PELL, *Circuit Judge,* dissenting in part, concurring in part.

At the risk of taking an overly simplified view of a more than ordinarily complicated example of tax law, and notwithstanding the scholarly analysis and treatment by the majority opinion of the issues presented, I respectfully dissent as to the matter of the tax benefit rule.

The ultimate situation appears to me as follows: When the losses which comprised the December 31, 1962, unpaid loss accrual were settled at less than the amount accrued therefor, Home Mutual received, in effect, a "recovery" of a prior expense. By means of bookkeeping entries these excess accruals were

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underwriting loss. This interpretation would seem to give deduction of the special transitional underwriting loss priority over the PAL deduction and thus create a conflict with the bare language of the statute, which allows the former deduction only after subtraction of the PAL deduction. However, Treasury Regulation § 1.824-1(a) resolves any ambiguity by explicitly providing that "statutory underwiting income" for purposes of computing the PAL deduction is "as defined in section 823(a)."

[45] *See also* Notes of Advisory Committee on Appellate Rules, Rule 39, subdivision (b); 28 U.S.C. § 2412.

eliminated from its liabilities and restored to its earned surplus. Under the "tax benefit rule," as developed by numerous court decisions (which decisions are discussed in the majority opinion), such recoveries of prior expenses are includable in taxable income *only* to the extent that some "tax benefit" was received from their deduction against taxable income in a prior year. In Home Mutual's case, no prior tax benefit was received from the accrual of its unpaid losses as of December 31, 1962, because mutual insurance companies, such as Home Mutual, were not taxed on their underwriting income prior to 1963. Therefore the tax benefit rule should preclude the inclusion of such recoveries in Home Mutual's taxable income for the years 1963 through 1975.

Although the Tax Court declined to label the basis for its holding as the "tax benefit rule," per se, it appears to me from the Tax Court's opinon that that court was recognizing the principles underlying the tax benefit rule as being applicable to the facts of the present case.

The majority opinion, as I read it, rests in part on the basis that applying the tax benefit rule to the present case would be an extension beyond any existing authority. It appears to me that the present situation is squarely of the type that calls for the application of the rule.

In sum, inasmuch as the taxpayer realized no real economic gain from its payment of the claims made against its policies, and it received no tax benefit from the excess accruals for unpaid losses made prior to 1963, it should not be subjected to tax on its subsequent recovery of these excess accruals. This is the essence of the long standing "tax benefit rule." *Dobson v. Commissioner,* 320 U.S. 489 (1943).

Because of the result I would reach in this case, it is not necessary for me to reach the cash subrogation recoveries issue. If I were to do so I would join in the remand provided for in Part II of the majority opinion with the exception that I find persuasive the reasoning in *American Financial Corp v. Commissioner,* 72 T.C. 506 (1979). I concur in Part III of the majority opinion.

United States Court of Appeals

For the Seventh Circuit

Nos. 79-1602 and 79-1603
HOME MUTUAL INSURANCE COMPANY,
Petitioner-Appellee,
Cross-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant,
Cross-Appelle.

Appeal from the United States Tax Court

ARGUED EN BANC NOVEMBER 13, 1980—
DECIDED DECEMBER 23, 1980

Before FAIRCHILD, *Chief Judge,* SWYGERT, CUMMINGS, PELL, SPRECHER, BAUER, WOOD and CUDAHY, *Circuit Judges.*

PER CURIAM. The sole issue before the full Court is whether a majority of the panel properly held that

the tax benefit rule[1] may not be invoked unless the items sought to be excluded from taxation are asserted to be taxable only by means of the exclusionary [sic] aspect of the tax benefit rule. For the reasons given in the majority panel opinion, we hold the tax benefit rule requires use of the inclusionary aspect of the rule before a taxpayer can employ the exclusionary aspect. ..... F.2d ....., ...

At the *en banc* oral argument, in a colloquy between bench and bar, counsel suggested that Sections 832(b)(5) and 821(e) of the Internal Revenue Code as interpreted and applied in this case, while ostensibly taxing income, in fact operate to impose a direct tax on property that is not apportioned according to population, in violation of Article I, Section 2, Clause 3 and Section 9, Clause 4 of the Constitution.[2] A tax on income, of course, need not be apportioned in view of the Sixteenth Amendment.[3] This argument appears to be founded on a confusion of "taxable

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[1] In *Putoma Corp. v. Commissioner*, 66 T.C. 652, 664 n. 10, affirmed, 601 F.2d 734 (5th Cir. 1979), the Tax Court described the tax benefit rule as follows:

> "both a rule of inclusion and exclusion; recovery of an item previously deducted must be *included* in income; that portion of the recovery not resulting in a prior tax benefit is *excluded.*"

As explained in the panel majority opinion in the present case, the tax benefit rule is not limited to the recoveries of deductions but also includes recoveries of items that had earlier resulted in tax credits and of funds, such as embezzled monies, that were never included in gross income. ..... F.2d ....., ... n. 26.

[2] Section 2, Clause 3 provides in pertinent part:

> "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers ***."

(Footnote continued on following page)

income" with "income." As then Judge Tone's majority opinion stated in its discussion of the tax benefit rule, this is not a case in which the Commissioner has added a "recovery" or recaptured loss to taxpayer's gross income. The bottom line effect of the relevant provisions here has been to reduce the amount of the "losses incurred" deduction allowable to taxpayer in 1966 and 1971, thereby increasing the amount of its taxable income for those years. ..... F.2d ....., ...

Taxable income is simply that portion of taxpayer's gross income that Congress has chosen to tax. The term "taxable" in no way connotes a constitutional limitation on the extent to which or the manner in which gross income may be taxed. To the contrary, it is well settled that Congress has the power to impose without apportionment an income or excise tax measured by gross income or gross receipts, even where an individual taxpayer has no net income after

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Section 9, Clause 4 provides:

> "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

[3] The Sixteenth Amendment provides:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

This amendment was added to the Constitution in response to the Supreme Court's invalidation of the Income Tax Act of 1894 in *Pollock v. Farmer's Loan & Trust Co.*, 157 U.S. 601 (initial decision), 158 U.S. 601 (decision on rehearing), on the ground that a tax on income derived from property was the equivalent of a direct tax on the income-producing property itself and therefore must be apportioned in accordance with the above-quoted provisions of Article I. Prior to the decision in *Pollock*, it had been the general consensus that the term "direct taxes" as used in the Constitution

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expenses, *Penn Mutual Indemnity Co. v. Commissioner of Internal Revenue*, 277 F.2d 16, 20 (3d Cir. 1960), and that deductions are generally a matter of legislative grace. *Idem.* Indeed, mutual insurance companies like taxpayer here were, as has already been noted in the panel majority opinion, prior to 1963 taxed on the basis of gross income, and that very tax was upheld in *Penn Mutual Indemnity Co., supra*, against constitutional attack similar to the one raised here. Congress has now chosen to use a different measure of taxation, one which allows a deduction for "losses incurred," but "losses incurred" only as defined and computed under the Code. This choice was a matter of legislative discretion and is not rendered constitutionally infirm for lack of apportionment because the resulting tax is not confined to or measured by taxpayer's actual net income.

The Tax Court's resolution of the unpaid losses dispute is reversed, with costs to the Commissioner.

CUDAHY, *Circuit Judge*, Concurring:

I agree with the majority of the full Court and of the panel that the decided cases, with the possible

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referred only to taxes on real estate and poll or capitation taxes. See, *e.g.*, *Hylton v. United States*, 3 U.S. (3 Dall.) 171, 177; *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533, 544; *Springer v. United States*, 102 U.S. 586, 602. In 1937, the Supreme Court effectively overruled *Pollock*, see *New York* ex rel. *Cohn v. Graves*, 300 U.S. 308, thereby making the Sixteenth Amendment superfluous. Congress' power to lay and collect income taxes does not, of course, derive from the Sixteenth Amendment, but from Article I, Section 8, Clause 1 of the Constitution, which provides in pertinent part:

> "The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and General Welfare of the United States ***."

exception of *American Financial Corp. v. Commissioner,* 72 T.C. 506 (1979), appear to employ the exclusionary aspect of the tax benefit rule only when the items sought to be excluded are asserted to be taxable by means of the inclusionary aspect. This is not in my view the case in which to introduce "flexibility" in a whole new dimension into the tax benefit rule. *Cf. First Trust & Savings Bank of Taylorville v. United States,* 614 F.2d 1142, 1145 (7th Cir. 1980). When such a case may be presented, however, I do not believe that the existing precedents necessarily constitute a complete bar to extension of the rule in some fashion as an exclusionary mechanism only.

FAIRCHILD, *Chief Judge,* with whom PELL and BAUER, *Circuit Judges,* join, dissenting in part and concurring in part. I respectfully dissent as to the unpaid losses disputed.

In any tax year after 1962, an estimate of a loss incurred in that year, but not settled, measures a deduction from underwriting income. In a later year, if that loss is settled for less than the estimate, the statute causes the difference to augment underwriting income. In these instances, the statute itself is consistent with the inclusionary aspect of the tax benefit rule. Our problem arises because the present statutory taxing system began at the close of 1962, and the statute makes no allowance for the fact that an estimate of a loss incurred in 1962 or before, but not settled, may in fact be larger than necessary. When such a claim is settled after 1962 for less than the estimate, the statute causes income to be increased by the amount of the difference. The same thing happens where a post-1962 loss is settled in a later year for less than the estimate, but in the latter case the taxpayer has previously been able to deduct the full amount of the estimate in a previous year. Not so with the pre-1963 loss.

Clearly enough Congress has power to treat the post-1962 loss in the manner it has.

The settlement after 1962 of the pre-1963 loss presents a different question. Read mechanically, the statute treats the amount by which the company overestimated the pre-1963 claim as taxable income in the post-1962 year in which the claim is settled; the company's tax is increased solely by reason of the fact that it paid a claim against its policies. This, however, is inappropriate, for the Sixteenth Amendment permits only the taxation of income, yet here the settlement produced none. When an unliquidated debt is discharged by an amount less than anticipated there is no gain or profit to the debtor, it receives nothing of value and is released from satisfying no obligation it was otherwise bound to perform.[1]

It seems to me that faced with a constitutional question, we are to look for constructions of the statute which might save it.[2]

A possible argument is that by taxing a mutual casualty insurance company's "recovery" of the amount by which it overestimated a pre-1963 claim, Congress is merely attempting to levy a tax on part of the company's previous income which under pre-1963

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[1] Of course the taxpayer is better off than it would have been had the claim been settled for a higher amount. The point, however, is that because it was never obliged to pay a higher figure, no benefit derived from the fact that the settlement cost less than estimated. The situation here is unlike the partial cancellation of liquidated debt, which usually results in a taxable income, for in the latter case the debtor is released from paying an amount he otherwise would be bound to pay. See generally, 3 Rabkin & Johnson, § 36.01.

[2] Home Mutual contended, both in its petition for reargument and at oral argument before the court sitting *en banc* that the relevant provisions of the statute as applied by the Commissioner should be held unconstitutional, but that this result could be avoided by invoking the exclusionary aspect of the tax benefit rule.

law escaped taxation. There is no dispute that, subject to certain limitations concerning harshness or arbitrariness of impact, Congress has the power to retroactively tax income, *see e.g., Lynch v. Hornby,* 247 U.S. 339, 343 (1918); *Brushaber v. Union Pacific Railroad,* 240 U.S. 1 (1916), but a statute will not be construed to do so in the absence of a "clear, strong, and imperative" declaration that such was the intent of Congress. *Shwab v. Doyle,* 258 U.S. 529, 535 (1922), quoting *United States v. Heth,* 3 Cranch 398, 413; see also *Rose v. Commissioner,* 55 T.C. 28 (1970). In the present case, quite simply, there is nothing expressed in the text of the relevant statute or in its legislative history capable of satisfying this requirement, and intent may not be inferred from the language of the Act.[3]

Clearly Congress intended to enact a valid statute, and it seems far more likely that Congress, in

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[3] It is not sufficient that an intent to levy a retroactive tax might reasonably be suggested by the terms of the statute. In *Shwab, supra,* the court found that the Act there in question "provided that ... a tax was to be imposed upon the transfer of the net estate of *every* decedent dying after passage of the act, 'to the extent of any transfer [made] ... in contemplation of ... death ...'" and that transfers made within two years of death without receipt of fair consideration were rebuttably presumed to have been made for such a purpose. 258 U.S. at 532 (emphasis added). The court nonetheless held that the Act should not be construed to apply to transactions completed before the Act became law and therefore held that the value of a trust created fifteen and a half months before passage of the Act was not taxable to the decedent's estate. It reasoned that "a statute should not be given a retroactive operation unless its words make that imperative and this [could not] be said of the words of the Act" then before the court. 258 U.S. 537.

Thus, in the present case, an intent on the part of Congress to retrospectively tax income should not be inferred from the language of the statute even though literal adherence to its terms might suggest such an intent.

designing a system consistent with the tax benefit rule, permitting the deduction of the estimated amount of a loss incurred after the effective date of the statute, but including in income in a later year the difference between the estimate and the lower amount of a settlement, intended that the principle of the tax benefit rule apply as well to an advantageous settlement after the effective date of the statute of a loss previously incurred.

Accordingly, I would affirm the Tax Court on this issue. I concur in Part III of the majority panel opinion.

PELL, *Circuit Judge,* dissenting in part, concurring in part.

While continuing to adhere to the views expressed in my dissent-concurrence to the opinion of Judge Tone, I also concur and join in the dissent-concurrence of Chief Judge Fairchild filed in the present *en banc* proceedings.

With all due respect to the majority *per curiam* opinion, it appears to me that it indulges in semantic unreality to avoid recognizing that in fact this taxpayer is being required to treat as taxable income a recovery from which it never had any benefit.

APPENDIX B

OPINION OF U.S. TAX COURT

Home Mutual Insurance Company, Petitioner *v.* Commissioner of Internal Revenue, Respondent

Docket No. 6587-75. Filed September 18, 1978.

Petitioner estimated its unpaid losses as of Dec. 31, 1962, when underwriting income first became taxable by an examination of each filed claim. In each of its subsequent taxable years it settled claims pending on Dec. 31, 1962, for less than the estimate. *Held,* petitioner is entitled to an adjustment in each of its taxable years for the difference between the amount of the estimated claim pending on Dec. 31, 1962, and the amount for which the claim was subsequently settled. *Held, further,* the special transitional underwriting loss reduction provided by sec. 821(e), I.R.C. 1954, applicable to the taxable years 1965, 1966, and 1967, is allowable only against statutory underwriting income after allowance of the protection against loss deduction permitted by sec. 824.

Paul A. Pakalski and *Michael T. Hart,* for the petitioner. *Nelson E. Shafer,* for the respondent.

OPINION

GOFFE, *Judge:* The Commissioner determined deficiencies in petitioner's Federal mutual insurance company income taxes for the taxable years 1966 and 1971 in the respective amounts of $29,906.21 and $18,624.50. The issues for decision are as follows:

(1) Should petitioner be permitted to adjust its estimate of unpaid losses as of December 31, 1962, in

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each of its subsequent taxable years based strictly upon settlements of its claims which had been estimated on that date;

(2) In the alternative, must recoveries (salvage and subrogation) on losses paid prior to January 1, 1963, be offset against losses incurred in a subsequent year for purposes of computing statutory underwriting income; and

(3) Is the special transitional underwriting loss an allowable reduction to the full extent of underwriting gain before the protection against loss deduction under section 824,[1] of the Internal Revenue Code, or only to the extent of statutory underwriting income after allowance of the protection against loss deduction.

The case was submitted upon a complete stipulation of facts. The stipulation of facts and exhibits attached thereto are incorporated by this reference.

Home Mutual Insurance Co. (petitioner) is a mutual casualty insurance company with its principal office at Appleton, Wis. Petitioner filed Federal mutual insurance company income tax returns (hereinafter referred to as returns) for the taxable years 1963, 1964, 1965, 1966, and 1967 with the District Director of Internal Revenue, Milwaukee, Wis., and like returns for the taxable years 1971 and 1972 with the Internal Revenue Service Center, Kansas City, Mo. Petitioner filed an amended return for the taxable year 1963 with the District Director of Internal Revenue, Milwaukee, Wis., on June 9, 1965.

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[1] All section references are to the Internal Revenue Code of 1954, as amended.

In each State (Wisconsin and 16 other States)[2] where petitioner is authorized to act as an insurer, petitioner is required to file statements of its financial condition and the results of its annual operations. These annual statements are presented on forms prescribed by the National Association of Insurance Commissioners and completed in accordance with instructions prepared by that organization.

A brief history and explanation of the general scheme of taxation of mutual fire and casualty insurance companies is in order to aid an understanding of the issues in this case. The Revenue Act of 1962 (Pub. L. 87-834) drastically increased the tax on mutual fire and casualty insurance companies. Prior to that time such companies were taxed under one of two formulas which produced the higher tax. Under one formula they were taxed at ordinary corporate rates on their investment income and were not taxed on their income from premiums (underwriting income). Under the other formula they paid a tax of 1 percent on their gross investment income plus their premium income less policyholder dividends. At the same time stock fire and casualty insurance companies were taxed at ordinary corporate income tax rates on their investment income and underwriting income. The 1962 Act was designed to tax the mutual companies on much the same basis as the stock companies, recognizing however, that while a stock company could pay extraordinary losses out of paid-in capital as well as accumulated profits, a mutual company was able to pay extraordinary losses only out of retained underwriting income. H. Rept. 1447, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 446; S. Rept. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 761. The 1962 Act, therefore,

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[2] Idaho, Indiana, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Missouri, Montana, Nevada, North Dakota, Oklahoma, Oregon, South Dakota, Utah, and Washington.

established a new scheme of taxation for mutual fire and casualty insurance companies under which they would be taxed for taxable years commencing after December 31, 1962, on both their investment income and underwriting income with certain modifications.

Under the 1962 Act, which became sections 821 through 826 of the Internal Revenue Code of 1954, as amended, a normal tax and surtax were imposed on "mutual insurance company taxable income."

Mutual insurance company taxable income consists of taxable investment income and statutory underwriting income with certain specified modifications. The case before us involves statutory underwriting income. That term, in general, means the premiums earned on insurance contracts less expenses incurred, losses incurred, deductions allowable under section 832(c), and modifications with which we are not concerned in this case.

1. *Loss Incurred Deduction*

The deduction allowed against statutory underwriting income for losses incurred is computed under section 832(b)(5) which provides:

> SEC. 832(b)(5) Losses Incurred. — The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:
>
> (A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.
>
> (B) To the result so obtained, add all unpaid losses outstanding at the end of the

taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

The first issue presented for decision involves the deduction for losses incurred for each of the taxable years 1963 through 1966 and 1971, liabilities for the first 3 years properly being before the Court by reason of loss carryovers.

The following schedule reflects the loss incurred deduction involved in each of the years:

Taxable year	*Claimed on tax return*	*Determined in statutory notice*	*Claimed in amended petition*	*Amount in dispute*
1963..	[1]$3,148,344.52	$3,071,255.44	$3,287,553.53	$216,298.09
1964....	3,023,573.82	3,004,779.83	3,111,107.06	106,327.23
1965....	3,002,569.02	2,993,200.41	3,016,564.59	23,364.18
1966....	3,563,129.09	3,547,468.39	3,569,133.90	21,665.51
1971....	5,339,165.39	5,339,165.39	5,340,329.39	1,164.00

[1]Amended tax return.

The adjustments to the loss incurred deduction made by the Commissioner in his statutory notice of deficiency were based upon his determination that loss recoveries in each of the years were not excludable from the related loss incurred deductions. Petitioner challenges that determination in the alternative. Petitioner's primary contention is that it is entitled to additional unpaid loss deductions brought about by satisfying claims during each of the years reflected above for less than was estimated as of December 31, 1962, to be its liability for such claims pending on that date.

Petitioner, on its annual statement as of December 31, 1962, reported its unpaid losses at $2,729,746. This amount represented petitioner's evaluation of the amount of money necessary to meet all contingencies

of claims against its insurance policies on that date. It was composed of $2,600,472 for losses which had been reported to it by its policyholders and analyzed case-by-case to ascertain the projected ultimate liability and $129,274, representing an estimate of the losses incurred but not reported to petitioner by its policyholders as of December 31, 1962. Prior to December 31, 1962, the loss incurred account on petitioner's books and records and financial statements had no effect on the Federal taxation of petitioner's income because mutual insurance companies were not taxable on underwriting income prior to the taxable year 1963. The loss incurred account as of December 31, 1962, did, however, affect petitioner's tax liabilities for taxable years beginning with the taxable year 1963 because of the manner in which the loss incurred deduction is computed. The unpaid losses outstanding at the end of the taxable year are added to the losses paid during the taxable year and the unpaid losses at the beginning of the taxable year are deducted from that total. Sec. 832(b)(5), *supra*. The portion of petitioner's unpaid loss deduction which was estimated for losses not yet reported as of December 31, 1962 ($129,274), was converted during the taxable year 1963 to reported losses. As losses were reported to the petitioner by policyholders in 1963 petitioner evaluated its liability for the claims, added such estimated liability to the portion of its losses incurred for reported losses, and reduced the portion attributable to unreported losses.

Petitioner's unpaid loss account balance at December 31, 1962, affected not only its loss incurred deduction for the taxable year 1963 but all of its taxable years through 1975 because all of the claims pending on December 31, 1962, were not finally settled until 1975. In 1963 and each of the subsequent years petitioner evaluated its unpaid losses in like manner as of December 31 which not only included claims filed in each year but also the unsettled claims which had

been pending on December 31, 1962, which it had evaluated as of December 31, 1962. The unpaid loss evaluation for December 31, 1963, and subsequent dates, unlike the evaluation on December 31, 1962, affected petitioner's loss incurred deduction and its tax liability for each immediately preceding and each immediately succeeding taxable year because of the effect on the formula prescribed by section 832(b)(5), *supra,* i.e., beginning and ending of the year balances of unpaid losses.

The parties have stipulated the following description of the method employed by petitioner in accounting for the settlement of claims: "As each claim was disposed of, net payments were charged to the losses incurred account while the balance in the unpaid loss account for such claim was credited to the losses incurred account, thus clearing the unpaid loss account for that claim." Although the description of accounting for settlement of the claims (unpaid losses) which were pending as of December 31, 1962, is not a very clear statement of how petitioner accounted for such items, the result is not in dispute. Because petitioner (subsequent to December 31, 1962) settled claims pending at December 31, 1962, for amounts less than it estimated them to be on that date, petitioner understated its deduction for losses incurred in the aggregate amount of $402,314.59 between January 1, 1963, and December 31, 1975. Such understatements of the loss incurred deduction can best be understood by some examples.

Section 832(b)(5) provides for computation of the loss incurred deduction as follows:

1. Losses paid during the taxable year.

\+ 2. Salvage and reinsurance recoverable at the end of preceding taxable year.

- 3. Salvage and reinsurance recoverable at the end of the taxable year.

+ 4. Unpaid losses at the end of the taxable year.

- 5. Unpaid losses at the end of the preceding taxable year (or beginning of taxable year).

= 6. Loss incurred deduction.

It is readily apparent that in all events the unpaid losses at the beginning of the taxable year will reduce the loss incurred deduction. If the unpaid losses at the beginning of any taxable year after January 1, 1963, are overestimated and such estimated loss is paid for less than the estimated amount, such overestimation will merely shift the impact of the overestimate from one taxable year to another. But an overestimate of the amount of unpaid losses as of December 31, 1962, does not merely shift the impact from one taxable year to another because the amount of unpaid losses on December 31, 1962, affects petitioner's tax liability for the first time as it was not taxable on underwriting income for prior taxable years. Because the amount of unpaid losses on December 31, 1962, reduces the loss incurred deduction for 1963 the effect of overstating that amount results in offsetting either the losses paid or the unpaid losses pending at the end of 1963 portions of the deduction to which petitioner would otherwise be entitled.

For example, assume that petitioner estimated all of its unpaid losses at $1 million on December 31, 1962, and included was a claim estimated at $500,000 which was settled in 1963 for $200,000. Assume further that during 1963 petitioner paid claims not pending on December 31, 1962, in the amount of $100,000 and on December 31, 1963, in addition to the unpaid losses which were pending on December 31, 1962, and not settled during 1963, it had unpaid losses of $800,000

which were reported to petitioner by the policyholders during 1963. When petitioner settled the $500,000 claim for $200,000, it reduced the unpaid loss account by $500,000 because the settled claim no longer represented a liability of petitioner to the policyholder. Because salvage and reinsurance recoverable are not involved, petitioner's loss incurred deduction would be computed as follows, applying the formula set forth above:

1.	Losses paid in 1963	$300,000
+ 4.	Unpaid losses at 12/31/63 ($1,000,000 - $500,000 + $800,000)	1,300,000
		1,600,000
- 5.	Unpaid losses at 12/31/62	1,000,000
= 6.	Loss incurred deduction	600,000

If petitioner had estimated the claim in the example at the amount it was settled for ($200,000) instead of its overestimate ($500,000), line 6 above would be $900,000 as follows:

1.	Losses paid in 1963	$300,000
+ 4.	Unpaid losses at 12/31/63 ($700,000 - $200,000 + $800,000)	1,300,000
		1,600,000
- 5.	Unpaid losses at 12/31/62	700,000
= 6.	Loss incurred deduction	900,000

It is apparent, therefore, that petitioner would have been deprived of $300,000 of its loss incurred deduction.

The formula which the Code prescribes for computation of the loss incurred deduction is similar to the following formula used in the computation of cost of goods sold where inventories are utilized:

Beginning inventory
+ Purchases
- Ending inventory
= Cost of goods sold

At the end of each of the taxable years involved, petitioner had the facts available to adjust that portion of its opening balance in the unpaid loss account for claims existing on December 31, 1962, which were settled during such taxable year. Because the adjustment could be made within the taxable year involved in closing the books for that year there is no violation of the concept of the annual accounting period. Such an adjustment is similar to an adjustment of an inventory. We have long held that a taxpayer is permitted to adjust inventories to conform to the facts in years before the Court. *Elm City Nursery Co. v. Commissioner,* 6 B.T.A. 89 (1927). In that case the taxpayer deliberately inflated inventory figures on its balance sheets to present a better financial picture for borrowing funds to finance the operations of the business. The Commissioner based his determination of tax upon the inflated amounts appearing on the books of the taxpayer. We found that the taxpayer proved that the books did not correctly reflect the beginning and ending inventories and we adjusted the cost of goods sold accordingly. The Commissioner acquiesced in that decision. VI-2 C.B. 2.

In *Baumann Rubber Co. v. Commissioner,* 4 B.T.A. 671 (1926), the taxpayer adjusted its opening inventory for crude rubber it had failed to include. The Commissioner, in his statutory notice of deficiency, allowed a lesser amount to be added to the opening inventory which could be substantiated and which we upheld.

These cases demonstrate that a taxpayer's beginning inventory is not etched in concrete if an appropriate adjustment is proposed during the correct accounting period before the Court. We see no reason

why the same reasoning should not be applied to the original estimate of unpaid losses of petitioner at December 31, 1962.

Respondent opposes the adjustment on several grounds. First, he argues that the unpaid loss account is not an accrual in the traditional accounting sense. We recognize that the unpaid loss entry at the end of each accounting period is nothing more than an educated guess as to petitioner's liability for claims filed during that year against insurance policies which are in force and effect on that date. We fail to see, however, why an adjustment should be precluded for that reason. Recognizing the amount to be an estimate to us seems all the more reason to permit adjustment of the amount in the annual accounting period during which transactions occur, making it apparent that the estimate is incorrect. The hindsight which respondent abhors occurs within the annual accounting period. That is not the same situation as adjusting an account in a subsequent accounting period long after ordinary business transactions demonstrate the error of the estimate.

The need to permit petitioner to adjust for the overestimation of unpaid losses as of December 31, 1962, is even more compelling in view of its being the first time that the unpaid loss account had any bearing on petitioner's tax liability. In Rev. Rul. 58-126, 1958-1 C.B. 13, which respondent vainly tries to distinguish, the Commissioner held that a savings and loan association could adjust its reserve for losses in 1957 established prior to 1952 when it was not subject to taxation without resulting in the production of income unless it diminished the reserve below the additions to the reserve after 1951 and less chargeoffs for bad debt losses after 1951 and plus recoveries charged to the reserve after 1951. If the reserve were so diminished, gross income was held to be realized to the

extent of the diminution. We hold that the same rationale should apply here and petitioner is entitled to make the adjustments which it proposes.

Respondent also relies upon *Pacific Mutual Life Insurance Co. v. Commissioner,* 48 T.C. 118 (1967), revd. on other grounds. 413 F.2d 55 (9th Cir. 1969). That case is distinguishable. The taxpayer adjusted its beginning reserves for certain categories of insurance based upon payments of some claims and upon a revaluation, using methods different from those originally used when the reserves were established. We found that the taxpayer had used "actuarial hindsight" in adjusting its beginning reserves downward. Petitioner here does not advocate such a procedure; its hindsight is strictly based upon actual settlements of the pending claims during the years it proposes adjustments. In the instant case petitioner does not rely upon "actuarial hindsight" but, instead, on "actuality hindsight." Petitioner here actually settled the claims, previously estimated, for which it seeks adjustment. The methods employed in establishing reserves for future claims to be filed against life insurance policies and those for casualty insurance policies are vastly different. In the case of life insurance the estimate is based upon averages or probabilities which are actuarily developed. By contrast, reserves for claims against casualty insurance policies which are involved here, are based upon applying the factor of settlement experience to each claim which has been actually filed.

Petitioner here proved what Pacific Mutual failed to prove; i.e., the exact liability incurred with respect to the claims included in the December 31, 1962, estimate. See *Pacific Mutual Life Insurance Co. v. Commissioner, supra,* at 130, 131. Such failure of proof by *Pacific Mutual* led us to state at page 131, "we cannot conclude that the reserves in question were either

overstated or understated." In the instant case respondent raises no such question; he recognizes that the reserve on December 31, 1962, was overstated. In *Pacific Mutual* we also held that the legislative history of the applicable section (not the section involved here) did not support the taxpayer's position. There is no legislative history for section 832(b)(5) to examine in the instant case. Moreover, there is no showing that the taxpayer relied upon Rev. Rul. 58-126, *supra,* in *Pacific Mutual.*

Although we hold for petitioner, we cannot agree with its reasons for permitting the adjustments. Petitioner attempts to characterize the overestimation of the unpaid loss account as resulting in an overstatement of income. Such characterization is erroneous. The overestimation had no bearing upon petitioner's gross income from its underwriting activities. The overestimation affected its deduction for losses incurred. After making such an erroneous characterization, petitioner argues the applicability of the tax benefit rule. We know of no case which holds that the absence of a tax benefit in the prior year gives rise to a deduction in the current year. Here, there was no tax benefit in the prior year. Cf. *Tennessee Carolina Transportation, Inc. v. Commissioner,* 65 T.C. 440 (1975), affd. 582 F.2d 378 (6th Cir. 1978). Indeed, we have recognized that, although we have not identified our theory as the tax benefit rule, when a casualty insurance company releases its excessive reserves, it constitutes taxable income only to the extent that the amount released consists of amounts previously deducted. *Dallas Title & Guaranty Co. v. Commissioner,* 40 B.T.A. 1022, 1031 (1939), revd. on other grounds 119 F.2d 211 (5th Cir. 1941). See also *Maryland Casualty Co. v. United States,* 251 U.S. 342 (1920). However, the taxpayer must prove what portion of the released reserve did not create a deduction in a

prior taxable year. *Massachusetts Fire & Marine Insurance Co. v. Commissioner,* 16 B.T.A. 625 (1929).

Petitioner also relies upon the Commissioner's audit policy to demonstrate that the unpaid loss account as adjusted is within the percentage of tolerance that a revenue agent is to allow. This argument is unpersuasive.

2. *Recoveries of Losses Paid Prior to January 1, 1963*

Because we have held that petitioner may adjust its estimate of unpaid losses pending on December 31, 1962, it is unnecessary for us to decide its alternative position as to the treatment of recoveries on losses paid prior to January 1, 1963.

3. *Special Transitional Underwriting Loss*

This issue involves the appropriate point at which the special transitional underwriting loss may be utilized to reduce statutory underwriting income; i.e., is it allowable against underwriting gain before the protection against loss (PAL) deduction or allowable against statutory underwriting income after the protection against loss deduction?

Petitioner sustained underwriting losses aggregating $936,698.29 for the taxable years 1957 through 1961. Such losses may be allowed as a special transitional underwriting loss under section 821(e) for petitioner's taxable years 1965, 1966, and 1967.

Because we have adopted petitioner's position with respect to adjustments for the overestimation of unpaid losses as of December 31, 1962, we need not consider petitioner's alternative contention as to respondent's restoring to underwriting gain recoveries on claims

settled prior to January 1, 1963. Petitioner's underwriting gain is, therefore, properly computed as follows:

	1965	*1966*	*1967*
Underwriting gain per statutory notice of deficiency	$102,083.01	$60,672.28	$287,609.39
Adjustments for overestimation of unpaid losses at Dec. 31,1962	23,364.18	21,665.51	16,518.47
			271,090.92
Recoveries on claims			[1]3,987.39
Underwriting gain redetermined	78,718.83	39,006.77	275,078.31

[1]This adjustment for recoveries on claims settled prior to Dec. 31, 1962, was not proposed in the statutory notice of deficiency but petitioner assumes this adjustment in all the computations in its brief; it will, therefore, be deemed a concession by petitioner.

The table on p. 956 [A-55] depicts the parties respective positions as to the appropriate point at which to allow the special transitional underwriting loss:

Section 821(e)(2) applicable to the years before the Court allows a *reduction* of statutory underwriting income for the underwriting losses of the 5 preceding taxable years not previously utilized.[3]

[3] SEC. 821(e)(2) Reduction of Statutory Underwriting Income. — For purposes of this part, the statutory underwriting income of a company described in paragraph (1) for the taxable year shall be the statutory underwriting income for the taxable year (determined without regard to this subsection) reduced by the amount by which —

(A) the sum of the underwriting losses of such company for the 5 taxable years immediately preceding January 1, 1962, exceeds

(B) the total amount by which the company's statutory underwriting income was reduced by reason of this subsection for prior taxable years.

Section 823(a) provides for the determination of statutory underwriting income.[4] In summary, that section determines statutory underwriting income under sections 831 and 832, and allows a deduction under section section 824(a).

Petitioner argues that section 821(e)(2) and section 824(a)(1) both allow deductions, that they are "locked in a collision course" and legislative history supports *allowance* of the special transitional underwriting loss as a *deduction* against underwriting gain. We disagree.

Section 821(e)(2) provides for a *reduction* of statutory underwriting income for the previous years' underwriting losses. Because it provides for a *reduction* of the statutory underwriting income, it is necessary to refer to section 823(a) which determines the statutory underwriting income and that section, together with sections 831 and 832, clearly allow the PAL deduction against underwriting gain in computing statutory underwriting income.

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[4] SEC. 823. DETERMINATION OF STATUTORY UNDERWRITING INCOME OR LOSS.

(a) In General. — For purposes of this part —

(1) The term "statutory underwriting income" means the amount by which —

(A) the gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income, exceeds

(B) the sum of (i) the deductions which would be taken into account in computing taxable income if the taxpayer were subject to the tax imposed by section 831, reduced by the deductions provided in section 822(c), plus (ii) the deductions provided in subsection (c) and section 824(a).

(2) The term "statutory underwriting loss" means the excess of the amount referred to in paragraph (1) (B) over the amount referred to in paragraph (1) (A).

SPECIAL TRANSITIONAL UNDERWRITING LOSS

	Petitioner's method			*Respondent's method*			*Petitioner's method*	*Respondent's method*
	1965	*1966*	*1967*	*1965*	*1966*	*1967*	*Totals*	
Underwriting gain as redetermined	$78,718.83	$39,006.77	$275,078.31	$78,718.83	$39,006.77	$275,078.31		
Special transitional underwriting loss	(78,718.83)	(39,006.77)	(275,078.31)	(28,873.47)	0	(167,289.39)	($392,803.91)	($196,162.86)
PAL deduction	(30,165.65)	(35,691.34)	(39,244.77)	(49,845.36)	(45,443.03)	(107,788.92)		
Statutory underwriting income.....	(30,165.65)	(35,691.34)	(39,244.77)	0	(6,436.26)	0		
Taxable investment income.....	160,126.42	170,413.21	183,003.02	160,126.42	170,413.21	183,003.02		
Subtraction from PAL account.....	30,165.65	35,691.34	39,244.77	49,845.36	45,443.03	107,788.92		
Unused loss deduction	(160,126.42)	(170,413.21)	(183,003.02)	(209,971.78)	(209,419.98)	(127,095.68)		
Mutual Insurance Co. taxable income	0	0	0	0	0	163,696.26	0	163,696.26
Unused loss carryover to 1968							($32,944.79)	0

There is no ambiguity in the statutory scheme, and the legislative history does not conflict with our interpretation.

Decision will be entered under Rule 155.

Reviewed by the Court.

CHABOT, *J.*, dissenting: The majority allow a mutual casualty insurance company to deduct the amounts by which it *overestimated* its losses (as of Dec. 31, 1962), the deductions being allowed when the actual losses were specifically determined. I would not allow these deductions, and so I respectfully dissent.

The deductions are not provided for in the statute. See *New Colonial Ice Co. v. Helvering,* 292 U.S. 435 (1934). The legislative history does not indicate a congressional intent to provide such deductions. The deductions are not provided for in regulations.

The statutory provision for calculation of the losses incurred deduction of mutual insurance companies had been enacted 42 years before it was first applied to mutual companies.[1] The provision initially applied to stock companies. There is no evidence that this provision was applied to stock companies with respect to December 31, 1921, estimates in the manner in which the majority now seek to apply it to mutual companies with respect to their December 31, 1962, estimates.

Would the majority require that a company which had *underestimated* its losses take into income the amount by which the losses are finally determined to exceed the original estimates? I find no authority for any such income inclusion, yet such an inclusion appears to be the necessary logical consequence to the majority's holding in the instant case.

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[1] Sec. 246(a)(6), Revenue Act of 1921, Pub. L. 67-98.

The majority note that failure to grant the relief requested will result in petitioner never being able to compensate for its original overestimation. This same point was dismissed in *Pacific Mutual Life Insurance Co. v. Commissioner,* 48 T.C. 118 (1967), revd. on other grounds 413 F.2d 55 (9th Cir. 1969), as follows (48 T.C. at 127):

> Petitioner contends that because of special circumstances existing at the end of 1957, it overestimated the beginning 1958 reserves in question, causing a corresponding increase in its 1958 taxable income. Petitioner argues from this that if the alleged overstatements are not corrected for 1958, its income tax liability will not only be erroneous for that year but, because of the nature of the tax computation required under the 1959 Act, it will never be corrected in any later year. Assuming, *arguendo,* that the 1959 Act would have such an irreparable effect on petitioner's tax liability, petitioner's argument, as stated, is a plea for equitable relief. Such an argument cannot be considered by this Court since we lack equity jurisdiction. *Commissioner v. Gooch Co.,* 320 U.S. 418 (1943); *Lorain Avenue Clinic,* 31 T.C. 141 (1958); *Edward P. Clay,* 46 T.C. 505 (1966).

In *Pacific Mutual Life,* 48 T.C. at 129, this Court stated that the general rule is that reserves, in absence of legislative exception, may not be retroactively adjusted for purposes of correcting errors of judgment in the original estimate. Also see *Rio Grande Building & Loan Association v. Commissioner,* 36 T.C. 657, 664 (1961). This rule should be applied to the instant case since there is no indication of congressional intent to the contrary.

The majority distinguish *Pacific Mutual* as involving "actuarial hindsight" whereas the instant case involves "actuality hindsight." But in *Pacific Mutual* this Court stated:

> Thus, even if we were of the view that Congress had expressed an intent to permit retroactive adjustment to beginning 1958 reserves, *which we are not,* we would still be required to hold against petitioner for failure to prove any overstatement in such reserves. [48 T.C. at 131. Emphasis supplied.]

Thus, in *Pacific Mutual* we did not say that if petitioner could prove the overstatement by actual experience, then it would be able to make retroactive adjustment. A necessary prerequisite is congressional intent to permit retroactive adjustment. The majority in the instant case admit they cannot find such an intent.[2]

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[2] The majority point to respondent's published position in a 1957 ruling. That ruling has been explained (Rev. Rul. 73-273, 1973-1 C.B. 79) as follows:

"Rev. Rul 58-126, 1958-1 C.B. 13, holds that a transfer in 1957 by a savings and loan association to its undivided profits of an amount from its reserve for losses that was set up from undivided profits during years prior to 1952, when such association was not subject to Federal income tax, did not result in gross income for Federal income tax purposes in the year of transfer. *Similarly,* in the instant case, the *valuation reserve accumulated in years prior to the taxpayer's becoming subject to Federal income tax also* represents undivided profits (accumulated earnings and profits) during years when it was not subject to Federal income tax and *is not relevant in determining gross income or deductions of any year during which the taxpayer is subject to such tax.* [Emphasis supplied.]"

Although the approach of the 1958 ruling may have been appropriate in the savings and loan association bad debt reserve area, it does not seem to be appropriate to extend that possible executive largeness.

(Footnote continued on following page)

It is not at all clear what would have been done if the Congress had focused on this question when the statute was extended to apply to mutual insurance companies. On the one hand, the equities presented in the majority's opinion would have argued for allowing the deduction. On the other hand, the Congress would have had to make a conscious decision to provide either (1) a "one-way-street" or (2) an inclusion of income for those companies that had underestimated their losses as of December 31, 1962. The Congress also would have had to recognize that the law would be more complicated, if it provided for these adjusting deductions and inclusions, than it would be under a "quick-and-dirty" approach. Since it is by no means clear to me that the Congress would have chosen to fine-tune the statute by requiring adjustments in all cases or by requiring only those adjustments that result in a lesser tax, I cannot with confidence say how the Congress would have acted. I would prefer to apply the statute as the Congress enacted it.

For the foregoing reasons, I would not allow the deductions sought in this case.

The majority concede that, under sec. 832(b)(5), the amount of the unpaid losses at the end of 1962 are indeed relevant in determining the loss incurred deduction for any year the petitioner is subject to tax. The real issue in the instant case is whether that admittedly relevant loss reserve can be retroactively adjusted and in the face of our statements in *Pacific Mutual Life Insurance Co. v. Commissioner*, 48 T.C. 118 (1967), the answer must be no.

APPENDIX C

Judgments of the Court of Appeals

United States Court of Appeals

For the Seventh Circuit

Chicago, Illinois 60604

April 29, 1980

Before

Hon. LATHAM CASTLE, Senior Circuit Judge

Hon. WILBUR F. PELL, Jr., Circuit Judge

Hon. PHILIP W. TONE, Circuit Judge

HOME MUTUAL INSURANCE COMPANY,
Petitioner-Appellee,
Cross-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant,
Cross-Appellee.

Nos. 79-1602 &
79-1603

Appeal from the United
States Tax Court

This cause came on to be heard on the transcript of the record from the Internal Revenue Service, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the United States Tax Court in this cause appealed from be, and the same is hereby, AFFIRMED IN PART, REVERSED IN PART, and REMANDED IN PART, in

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accordance with the opinion of this court filed this date. The costs of this appeal will be taxed against Home Mutual.

United States Court of Appeals

For the Seventh Circuit

Chicago, Illinois 60604

July 22, 1980

Before

Hon. THOMAS E. FAIRCHILD, Chief Judge
Hon. LUTHER M. SWYGERT, Circuit Judge
Hon. WALTER J. CUMMINGS, Circuit Judge
Hon. WILBUR F. PELL, JR., Circuit Judge
Hon. ROBERT A. SPRECHER, Circuit Judge
Hon. WILLIAM J. BAUER, Circuit Judge
Hon. HARLINGTON WOOD, JR., Circuit Judge
Hon. RICHARD D. CUDAHY, Circuit Judge

HOME MUTUAL INSURANCE COMPANY,
Petitioner-Appellee,
Cross-Appellant

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant,
Cross-Appellee

Nos. 79-1602, 79-1603

Appeal from the United
States Tax Court

ORDER

On consideration of the petition for rehearing and suggestion for rehearing *in banc* filed in the above-entitled cause by the appellee, cross-appellant, a majority of the judges of this Court in regular active

service have voted to grant a rehearing *in banc*. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, GRANTED.

IT IS FURTHER ORDERED that the Court's judgment and opinion of April 29, 1980 be, and the same is hereby, VACATED.

The cause will be set for oral argument at the convenience of the Court.

United States Court of Appeals

For the Seventh Circuit

Chicago, Illinois 60604

CORRECTED — JANUARY 21, 1981

December 23, 1980

Before

Hon. THOMAS E. FAIRCHILD, Chief Judge
Hon. LUTHER M. SWYGERT, Circuit Judge
Hon. WALTER J. CUMMINGS, Circuit Judge
Hon. WILBUR F. PELL, JR., Circuit Judge
Hon. ROBERT A. SPRECHER, Circuit Judge
Hon. WILLIAM J. BAUER, Circuit Judge
Hon. HARLINGTON WOOD, JR., Circuit Judge
Hon. RICHARD D. CUDAHY, Circuit Judge

Nos. 79-1602 and 79-1603

HOME MUTUAL INSURANCE COMPANY,
Petitioner-Appellee,
Cross-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant,
Cross-Appellee.

Appeal from the United
States Tax Court

This cause was heard, and reheard en banc, on the record from the United States Tax Court, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said Tax Court in this cause appealed from be, and the same is hereby, AFFIRMED IN PART, REVERSED IN PART, AND REMANDED IN PART, in accordance with the opinions of this Court filed April 29, 1980, and December 23, 1980. Costs on the entire appeal are to be assessed against Home Mutual Insurance Company.

APPENDIX D

Statutes & Regulations

Internal Revenue Code of 1954, Section 111:

§111. Recovery of bad debts, prior taxes, and delinquency amounts.

(a) General rule. Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) Definitions. For purposes of subsection (a) —

(1) Bad debt. The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) Prior tax. The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) Delinquency amount. The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) Recovery exclusion. The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not

result in a reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subschapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

(c) Special rules for accumulated earnings tax and for personal holding company tax. In applying subsections (a) and (b) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies) —

(1) a recovery exclusion allowed for purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) where a bad debt, prior tax, or delinquency amount was not allowable as a deduction or credit for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then a recovery exclusion shall be allowable if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under section 531 or the tax under section 541.

Internal Revenue Code of 1954, Subsections 821(a) and (b):

§821. Tax on mutual insurance companies to which part II applies.

(a) Imposition of tax. A tax is hereby imposed for each taxable year beginning after December 31, 1963, on the mutual insurance company taxable income of every mutual insurance company (other than a life insurance company and other than a fire, flood, or marine insurance company subject to the tax imposed by section 831). Such tax shall consist of —

(1) Normal tax. A normal tax of 22 percent of the mutual insurance company taxable income, or 44 percent of the amount by which such taxable income exceeds $6,000, whichever is the lesser; plus

(2) Surtax. A surtax on the mutual insurance company taxable income computed as provided in section 11(c) as though the mutual insurance company taxable income were the taxable income referred to in section 11(c).

(b) Mutual insurance company taxable income defined. For purposes of this part, the term "mutual insurance company taxable income" means, with respect to any taxable year, the amount by which —

(1) the sum of —

(A) the taxable investment income (as defined in section 822(a)(1)),

(B) the statutory underwriting income (as defined in section 823(a)(1)), and

(C) the amounts required by section 824(d) to be subtracted from the protection against loss account, exceeds

(2) the sum of —

(A) the investment loss (as defined in section 822(a)(2)),

(B) the statutory underwriting loss (as defined in section 823(a)(2)), and

(C) the unused loss deduction provided by section 825(a).

Internal Revenue Code of 1954, Subsection 823(a):

§823. Determination of statutory underwriting income or loss.

(a) In general. For purposes of this part —

(1) The term "statutory underwriting income" means the amount by which —

(A) the gross income which would be taken into account in computing taxable income under section 832 if the taxpayer were subject to the tax imposed by section 831, reduced by the gross investment income, exceeds

(B) the sum of (i) the deductions which would be taken into account in computing taxable income if the taxpayer were subject to the tax imposed by section 831, reduced by the deductions provided in section 822(c), plus (ii) the deductions provided in subsection (c) and section 824(a).

(2) The term "statutory underwriting loss" means the excess of the amount referred to in paragraph (1) (B) over the amount referred to in paragraph (1) (A).

Internal Revenue Code of 1954, Subsections 832(a), (b), and (c):

§832. Insurance company taxable income.

(a) Definition of taxable income. In the case of an insurance company subject to the tax imposed by section 831, the term "taxable income" means the gross income as defined in subsection (b) (1) less the deductions allowed by subsection (c).

(b) Definitions. In the case of an insurance company subject to the tax imposed by section 831 —

(1) Gross income. The term "gross income" means the sum of —

(A) the combined gross amount earned during the taxable year, from investment imcome and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners,

(B) gain during the taxable year from the sale or other disposition of property, and

(C) all other items constituting gross income under subchapter B, except that, in the case of a mutual fire insurance company described in section 831(a)(3)(A), the amount of single deposit premiums paid to such company shall not be included in gross income,

(D) in the case of a mutual fire or flood insurance company described in section 831(a)(3)(B), an amount equal to 2 percent of the premiums earned on insurance contracts during the taxable year with respect to policies described in section 831(a)(3)(B) after deduction

of premium deposits returned or credited during the same taxable year, and,

(E) in the case of a company which writes mortgage guaranty insurance, the amount required by subsection (e) (5) to be subtracted from the mortgage guaranty account.

(2) Investment income. The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends, and rents, computed as follows: To all interest, dividends, and rents received during the taxable year, add interest, dividends, and rents due and accrued at the end of the taxable year, and deduct all interest, dividends, and rents due and accrued at the end of the preceding taxable year.

(3) Underwriting income. The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred.

(4) Premiums earned. The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

(A) From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance.

(B) To the result so obtained, add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year.

For purposes of this subsection, unearned premiums shall include life insurance reserves, as defined in section 801(b), pertaining to the life, burial, or funeral insurance, or annuity business of

an insurance company subject to the tax imposed by section 831 and not qualifying as a life insurance company under section 801. For purposes of this subsection, unearned premiums of mutual fire or flood insurance companies described in section 831(a)(3)(B) means (with respect to the policies described in section 831(a)(3)(B)) the amount of unabsorbed premium deposits which the company would be obligated to return to its policyholders at the close of the taxable year if all of its policies were terminated at such time; and the determination of such amount shall be based on the schedule of unabsorbed premium deposit returns for each such company then in effect. Premiums paid by the subscriber of a mutual flood insurance company referred to in paragraph (3) of section 831(a) shall be treated, for purposes of computing the taxable income of such subscriber, in the same manner as premiums paid by a policyholder to a mutual fire insurance company referred to in such paragraph (3).

(5) Losses incurred. The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

(A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.

(B) To the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

(6) Expenses incurred. The term "expenses incurred" means all expenses shown on the annual

statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows: To all expenses paid during the taxable year, add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the taxable income subject to the tax imposed by section 831, there shall be deducted from expenses incurred (as defined in this paragraph) all expenses incurred which are not allowed as deductions by subsection (c).

(c) Deductions allowed. In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:

(1) all ordinary and necessary expenses incurred, as provided in section 162 (relating to trade or business expenses);

(2) all interest, as provided in section 163;

(3) taxes, as provided in section 164;

(4) losses incurred, as defined in subsection (b) (5) of this section;

(5) capital losses to the extent provided in subchapter P (sec. 1201 and following, relating to capital gains and losses) plus losses from capital assets sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Capital assets shall be considered as sold or exchanged in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders to the extent that the gross receipts from their sale or exchange are not greater than the excess, if any, for the taxable year

of the sum of dividends and similar distributions paid to policyholders in their capacity as such, losses paid, and expenses paid over the sum of the items described in section 822(b) (other than paragraph (1) (D) thereof) and net premiums received. In the application of section 1212 for purposes of this section, the net capital loss for the taxable year shall be the amount by which losses for such year from sales or exchanges of capital assets exceeds the sum of the gains from such sales or exchanges and whichever of the following amounts is the lesser:

(A) the taxable income (computed without regard to gains or losses from sales or exchanges of capital assets or to the deductions provided in section 242 for partially tax-exempt interest); or

(B) losses from the sale or exchange of capital assets sold or exhcanged to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders;

(6) debts in the nature of agency balances and bills receivable which become worthless within the taxable year;

(7) the amount of interest earned during the taxable year which under section 103 is excluded from gross income;

(8) the depreciation deduction allowed by section 167 and the deduction allowed by section 611 (relating to depletion);

(9) charitable, etc., contributions, as provided in section 170;

(10) deductions (other than those specified in this subsection) as provided in part VI of subchapter B (sec. 161 and following, relating to itemized deductions for individuals and corporations) and in part I of subchapter D (sec. 401 and following, relating to pension, profit-sharing, stock bonus plans, etc.);

(11) dividends and similar distributions paid or declared to policyholders in their capacity as such, except in the case of a mutual fire insurance company described in section 831(a)(3)(A). For purposes of the preceding sentence, the term "dividends and similar distributions" includes amounts returned or credited to policyholders on cancellation or expiration of policies described in section 831(a)(3)(B). For purposes of this paragraph, the term "paid or declared" shall be construed according to the method of accounting regularly employed in keeping the books of the insurance company;

(12) the special deductions allowed by part VIII of subchapter B (sec. 241 and following, relating to partially tax-exempt interest and to dividends received); and

(13) in the case of a company which writes mortgage guaranty insurance, the deduction allowed by subsection (e).

Treasury Regulations on Income Tax:

§1.111-1 Recovery of certain items previously deducted or credited.

(a) General. Section 111 provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the

"recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127 of the Internal Revenue Code of 1939, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. The term "recovery exclusion" as used in this section means an amount equal to the portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in section 111), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under subtitle A (other than the accumulated earnings tax imposed by section 531 or the personal holding company tax imposed by section 541) of the Internal Revenue Code of 1954 or corresponding provisions of prior income tax laws (other than the World War II excess profits tax imposed under subchapter E, chapter 2 of the Internal Revenue Code of 1939).